A PUBLIC POLICY PRACTICE NOTE

Optional Retrospective Application of ASU 2010-26 Acquisition Costs

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Participating Members from the 2011 Life Financial Reporting Committee

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Elizabeth Rogalin, FSA, MAAA

This practice note was prepared by the Life Financial Reporting Committee of the American Academy of Actuaries. Please address all communications to LifeAnalyst@actuary.org

Background

In October 2010, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts.* ASU 2010-26 will become effective for most companies on January 1, 2012. ASU 2010-26 revises the definition of the acquisition costs that are deferrable. As a result of these changes, actuaries responsible for Generally Accepted Accounting Principles (GAAP) valuation will likely be asked to consult on, or assist with, potential changes to deferred acquisition cost (DAC) calculations (including possible retrospective application of the requirements). This document provides information on some of the relevant actuarial issues. However, please note that this practice note is not meant to supplant the reader's responsibility to review the full ASU guidance to the extent it is applicable to his or her practice

1. Briefly, how does the guidance change deferrable expenses?

   Prior to the issuance of ASU 2010-26, deferrable expenses were defined as those costs that "vary with and are primarily related to the acquisition of insurance contracts." Under the revised guidance, only those costs that are "related directly to the successful acquisition of new or renewal insurance contracts" are eligible for deferral.

   In order to be "related directly," acquisition expenses must be "incremental direct costs…that result directly from and are essential to the contract transaction(s) and would not have been incurred…had the contract transaction(s) not occurred."

   One major consequence of the new definition is to exclude acquisition expenses related to unsuccessful sales efforts (e.g., policies not taken, unsuccessful sales calls) and indirect costs (e.g., rent costs for sales staff).

   It is unlikely that any expenses that are not considered deferrable under current US GAAP would be considered deferrable under ASU 2010-26. Details of applying the new deferability rules to actual expenses are typically handled by accountants, and thus out of scope of this practice note. However, the new guidance will affect the amount of future deferrable expenses that can be capitalized.

2. The guidance is effective for fiscal years (and interim periods within those fiscal years) beginning after December 15, 2011 (effectively January 1, 2012 for most companies), with early application permitted The ASU permits but does not require retrospective application to all prior periods. If the company chooses not to apply the guidance retrospectively, what are the actuarial considerations? What are the reporting and disclosure requirements for retrospective application?

   Actual deferrable expenses will be determined in accordance with the new guidance, and input into the DAC calculation in the same way as previously. These amounts would generally be expected to be smaller than those under the previous guidance, resulting in lower deferrals and lower amortization.

ASC 250-10-45-5-7 provides guidance on the reporting and disclosure requirements for companies that elect retrospective adoption:

- cumulative effect of the change on periods prior to those presented in the carrying amounts of assets and liabilities;
- an offsetting adjustment, if any, to the opening balance of retained earnings for that period;
- financial statements for each individual prior period presented adjusted to reflect the period-specific effects of applying the new accounting principle.

Disclosure requirements for companies that do not elect retrospective adoption are more extensive, because future periods would be on an inconsistent basis from historical periods.

3. What issues should be considered as a company decides whether or not to apply the guidance retrospectively?

All other things being equal, retrospective application of ASU 2010-26 may result in more consistent and comparable GAAP results before and after the change. As was stated before, the application of ASU 2010-26 will generally result in lower ongoing new deferral amounts. This will generally cause a decrease in GAAP operating earnings and net income for an ongoing operation. If a company does not adopt retrospective application, new DAC cohort schedules will be on a different basis than old cohorts, and a full transition to the new standard will not occur until all old business has rolled off of the DAC models. Retrospective application of ASU 2010-26 allows a company to report existing business on the same basis as new business. Retrospective application will therefore generally decrease DAC balances, resulting in lower impacts to GAAP operating earnings and net income in future years. In order to apply the ASU retrospectively, historical information is required. Technical Inquiry Service (TIS) Section 6300.38 published by the American Institute of Certified Public Accountants (AICPA) address the accounting issues further.

However, retrospective application of ASU 2010-26 would be expected to reduce GAAP capital. As a result, measurements such as debt-to-capital ratios and book value amounts could be negatively affected. If the company has existing contractual arrangements (and is unable to renegotiate the stated contractual thresholds), the company may not wish to adopt ASU 2010-26 retrospectively.

If a company decides to retrospectively adopt ASU 2010-26 the company will generally need to restate prior quarterly and annual results using the retrospective application of ASU 2010-26. For example, SEC 10-K and 10-Q supplemental financial statements often contain quarterly and annual comparison figures that will be much more usable if restated on a truly comparable basis. Other company public information and management information may need to be reviewed and updated as well.

4. Which actuarial items may change if retrospective application is elected?

The items that are likely to change are DAC balances, Deferred Tax Assets (DTAs), shadow DAC balances, shadow DTAs, and the deferred profit liabilities associated with limited pay contracts.

DAC balances will likely change due to the revision of historical deferrable expenses, which will also affect the amortization ratio, or "k-ratio." Other DAC-related considerations may also be affected. For example, the DAC amortization related to unrealized gains or losses that is recorded through an adjustment to Other Comprehensive Income (the so-called "shadow adjustment") would change. In addition, to the extent DAC balances are limited by the initial amount capitalized, those caps would also change. Another item that may be affected is reinsurance receivable balances to the extent that the initial receivable balance was capped to avoid a gain at inception based on the existing direct DAC at the time of inception.

Deferred Profit Liability (DPL) associated with Limited Pay contracts as defined by ASC 944-20-20 (FAS 97) may change as a result of application of ASU 2010-26 (this DPL is sometimes referred to as an unearned revenue liability). Although the assumptions used in the calculations of the reserves are locked-in at issue as specified in ASC 944-40-35-5 (FAS 60), ASC 944-605-25-4A (FAS 97) requires that the "loading," which equals any gross premium in excess of the net premium, be deferred. Initial DPL is therefore determined as the difference between the gross premiums, net benefit premiums and net expense premium (consisting of an acquisition and a maintenance component). A change in the acquisition component due to application of ASU 2010-26 may change DPL. However, the rate of amortization of DPL may not change.

Some companies may use an implicit approach to accounting for limited pay contracts, where the GAAP policyholder benefit liabilities are calculated using a break-even interest rate method such that at issue, the present value of benefits, theoretical unearned revenue liability and maintenance expenses calculated at locked-in best estimate assumptions with PAD is equal to the gross premium received less deferrable acquisition expenses. As application of ASU 2010-26 typically reduces deferrable acquisition expenses, the gross premium received less DAC will increase, resulting in a lower break-even interest rate, higher initial GAAP liabilities (and implicit URL) and higher subsequent GAAP profits, while benefits and expenses are unchanged.

If retrospective application is applied to FAS 97 limited pay contracts, the unreleased profit liability may change because the amount of profit during the premium paying period could change. In addition, if the limited pay liability changes, any shadow loss recognition liability associated with those contracts may change as well.

Deferred tax assets or liabilities may also change as a result of changes to DAC, shadow DAC and shadow loss recognition liabilities.

Sales inducement assets and unearned revenue liabilities for services to be provided in future periods associated with universal life-type contracts are not likely to change as a result of retrospective application. So unless estimated gross profits (EGPs) are changed, which is unlikely, there would probably not be an impact to these items. EGPs are discussed further in question 10 below. However, depending on the facts and circumstances, unearned revenue liabilities established for origination fees in excess of non-deferrable acquisition costs may change as a result of retrospective application.

Reinsurance expense allowance assets and liabilities on third party reinsurance agreements may not change since the reinsured contracts were successfully sold and non-commission based expense allowance may be determined by a formula. However, if the amounts of reinsurance receivables at inception of a reinsurance contract were affected by the amount of direct DAC, the reinsurance receivable may need to be revised. Also, companies should consider consolidation issues in the case of reinsurance with subsidiaries and sister companies. Careful attention should be given to the language concerning reimbursement for deferrable or sales related expenses.

5. If the company elects to apply the guidance retrospectively, what will the actuary need to do to calculate the revised DAC balances?

   Ideally, actuaries will be provided with revised deferrable amounts for all issue years for which the company currently holds a DAC balance. The actuary would likely have responsibility for recalculating the unamortized DAC balance as of the earliest financial statement period presented using the revised deferrable amounts.

   Restated DAC balances as of prior reporting date ideally would be based on assumptions that were in effect as of those periods, excluding any subsequent unlocking. Using the ratio method described in question 7 applied to the DAC balances that were in effect as of each prior reporting date would automatically reflect the assumptions that were used as of that date.

   Please see below for considerations where such data is not readily available.

6. How could the company calculate or estimate revised deferrable expenses for all issue years, if data is not readily available?

   There may be three critical periods for performing the retrospective adoption. For some period prior to the effective date of ASU 2010-26, sufficiently detailed data may exist from which to calculate the period specific adjustments to deferrable expenses to recalculate DAC and DAC-related balances. There may also be a period prior to this for which detailed information may not be available, but for which sufficient information exists from which the actuary can make a reasonable estimate of the cumulative adjustment. For earlier periods, for which no detailed data is available or for which a reasonable estimate cannot be made, no adjustment is permitted, in accordance with TIS 6300.38. Also, per Accounting Standards Codification (ASC) 250-10, a cumulative adjustment can only be made if the amount can be calculated or estimated.

If there have been loss recognition or recoverability write downs of DAC in the past, the amount may have been different if the new guidance was in effect at the time of the write down. In some instances, the write down may not have occurred at all under the new guidance, since the amount of capitalization and the DAC balance would likely have been lower. In this case of eliminating the entire premium deficiency on contracts with locked-in assumptions, deferred acquisition costs and policy liabilities may need to be recalculated using prior locked-in assumptions. Adjusting for revised write down amounts may thus be a complicating factor in estimating the revised DAC balance.

If any errors have been identified and corrected in the past, it would be appropriate to base the cumulative adjustment on the corrected amounts.

7. Can the actuary recalculate DAC for all issue years without rerunning DAC models or valuation system?

   Yes. If it is not feasible to rerun the DAC models, it may be possible to recalculate DAC by applying a ratio approach, as follows. As long as the denominator of the amortization ratio is unchanged (see questions 9 and 10 below), and there have been no loss recognition or recoverability issues in the past, the current DAC balance of each cohort may be reduced based on the proportion of revised deferrable expenses to original deferrable expenses. The actuary may need to consider any material adjustments related to ASC 944-30-55-11 (SOP 05-1) before applying the reduction.

   However, if the acquisition expenses in the first year change by a different percentage than acquisition expenses in renewal years, then the answer could be different. And, if there are material renewal acquisition expenses then the answer could be materially different. As always, materiality and professional judgment will influence the approach used.

8. What considerations apply if the deferrable amount has been either capped or increased (due to negative amortization) in prior periods?

   When applying ASU 2010-26 retrospectively, care is required in situations where negative amortization has occurred in prior periods as a result of negative gross profits or negative gross margins. If DAC balances have been capped to prevent them from exceeding some amount based on the original acquisition costs capitalized, then the capping may need to be re-determined to reflect the reduction in the initial capitalized acquisition expenses. In a simple situation with no material acquisition expenses in renewal years and no write-down of DAC, the ratio approach described in question 7 may be appropriate.

9. Are there any special issues or considerations for traditional long duration contracts?

   Since FAS 60 DAC is amortized based on premiums, which will not change under ASU 2010-26, it may be possible to calculate retrospective application to DAC balances using the ratio approach described in question 7, above.

   Note that to the extent that a FAS 60 DAC model uses projected expenses rather than actual expenses, the new guidance does not explicitly permit truing up those projected expenses.

   ASU 2010-26 does not permit or require any other changes to FAS 60 DAC assumptions, unless resulting from a direct impact of retrospective adoption.

10. Will estimated gross profits (EGPs) or estimated gross margins (EGMs) change as a result of the changes to deferrable expenses?

    ASC 944-30-35-5 and ASC 944-30-35-13 provide guidance on the elements to be included in EGP and EGM estimates. These estimates include costs incurred for contract administration which include certain non-capitalizable acquisition costs, predominantly ultimate level commissions and recurring premium taxes. Any other acquisition costs should not be included in EGP/EGM. ASU 2010-26 did not change the guidance for estimating gross profits or the methods for DAC amortization. As such, it appears that costs that were previously capitalized as acquisition costs that are no longer capitalizable, should not be included in EGP/EGM.