



AMERICAN ACADEMY of ACTUARIES

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December 15, 2017

Ms. Susan M. Cospers  
Technical Director  
Financial Accounting Standards Board  
401 Merritt 7, PO Box 5116  
Norwalk, CT 06856-5116  
Submitted via email to: [acasas@fasb.org](mailto:acasas@fasb.org)

Re: Proposed Accounting Standards Update: *Financial Services – Insurance (Topic 944) Targeted Improvements to the Accounting for Long-Duration Contracts*

Dear Technical Director Cospers,

On behalf of the Financial Reporting Committee of the American Academy of Actuaries<sup>1</sup>, I appreciate the opportunity to identify a concern with one aspect of the proposed updates to insurance accounting that was not reconsidered during recent Board meetings.

Our concern is with respect to a provision (paragraph 944-605-35-2) in current standards, which ties the amortization of unearned revenue liabilities (URL) to the provisions for amortization of deferred acquisition costs (DAC). Those provisions effectively match both acquisition costs and front-end loads to the performance of the contract. Though the proposed updates do not alter this paragraph, the referenced DAC provisions (section 944-30-35, beginning with paragraph 35-3) are changing.

When it first adopted paragraph 944-605-35-2 (then a part of SFAS 97 paragraph 20), the 1987 board recognized two functions of front-end loads:

- as “compensation ... for services to be provided in future periods” and
- as “consideration for origination of the contract....”

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<sup>1</sup> The American Academy of Actuaries is a 19,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policy makers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

The proposed updates for DAC amortization are much simpler than current standards and will produce a reasonable matching of acquisition costs to the performance of the contract. When applied to URL, however, these updates will often result in some conceptual and mathematical distortions, and will introduce further uncertainty in the calculation of additional liabilities when required under paragraphs 944-40-25-27 and 25-27A.

**When front-end loads are not tied directly to new deposits, we recommend that the measurement of the URL be aligned with the proposed measurement of the deferred profit liability (DPL). Conceptually, such loads are more closely related to limited-pay premiums than to acquisition costs.**

Briefly, the second function recognized by the 1987 board drew a conceptual link between DAC and URL and wrote into SFAS 97 a mathematical equivalence between them by discounting expected cash flows and anticipating future deferrals. The proposed updates presume the conceptual link remains valid even for newer product designs that are inconsistent with this link. For such products, the distortion introduced by this treatment is explained and illustrated in Attachment I.

The first function recognized by the 1987 board, “compensation ... for services to be provided in future periods,” was also recognized in the then-new standards for DPL on limited-pay contracts and its treatment was made similar to the treatment of URL. Applying the proposed updates for DAC to URL removes this conceptual link along with the mathematical similarity to DPL that exists in current standards, since the DPL still accrues interest and anticipates future cash flows.

The advantage of aligning URL amortization with DPL is further supported when considering the additional liability that is sometimes required (beyond the account value and URL) under either paragraph 944-40-25-27 or paragraph 25-27A. To calculate a benefit ratio it is necessary to project assessments, which include amortization of URL. If the amortization of URL is based on DAC amortization standards, it is unclear whether that projection should or should not take into account expected future deferrals of front-end loads. That ambiguity could lead to different interpretations and inconsistent practice. If the amortization of URL is based on DPL, then it is clear that expected future deferrals of front-end loads would be included and there is no ambiguity.

For front-end loads that are automatically charged against the contract for as long as it remains in force during the specified limited-pay period, we reiterate the recommendation we made in our original comment letter on the exposure draft, that accounting for URL

be aligned with accounting for DPL.<sup>2</sup> As with premiums on limited-pay contracts, the substance of such charges is consistent with SFAS 97’s “compensation ... for services to be provided in future periods...” Making this change would restore this conceptual function of URL to match revenues with performance of the contract and better align its treatment with that of DPL. This is further explained and its effect illustrated in Attachment II.

For front-end loads that are tied directly to new deposits, we believe it would be appropriate to retain the link between DAC and URL amortization. The substance of such charges is consistent with SFAS 97’s “consideration for origination of the contract...” Because charges cannot be used twice—to offset acquisition costs and to fund future benefits—the assessments used in calculating additional liabilities should include neither this type of charge nor its amortization.

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Thank you for the opportunity to provide further feedback to the FASB on the proposed changes to the accounting for long duration contracts. If you have any questions or would like to discuss these issues in more detail, please contact Nikhail Nigam, the Academy’s policy analyst for risk management and financial reporting, at 202-785-7851 or [nigam@actuary.org](mailto:nigam@actuary.org).

Sincerely,

Steven F. Malerich, MAAA, FSA  
Vice-Chairperson, Financial Reporting Committee  
Risk Management and Financial Reporting Council

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<sup>2</sup> See response to question 16 (pp. 21-22) in the Academy’s letter: [HYPERLINK](#) (Dec. 14, 2016)

# Attachment I

## Applying New DAC Standards to URL

In our experience, acquisition costs for universal life contracts are normally concentrated at or near the issue date of a contract, but front-end loads are often collected over many years if the contract remains in force, without any direct link to new deposits or the absence thereof.

In adopting SFAS 97, the 1987 board matched both expenses and revenues to contract performance by discounting future acquisition costs and front-end loads to the date of issue when determining amortization rates for DAC and URL. In effect, the 1987 board equalized DAC and URL by amortizing discounted expected cash flows and accruing interest on the unamortized balances.

Consider a simple example where DAC and URL are made equivalent under current section 944-30-35. For a 50-year contract with a \$100,000 face amount: first year acquisition costs per policy are \$1,000; there are no renewal acquisition costs; an annual load of \$90 per-policy is charged for the first 20 years. Assuming a contract rate of 4 percent and an annual lapse rate of 3 percent, and using face amount as the amortization basis (to simplify comparison):

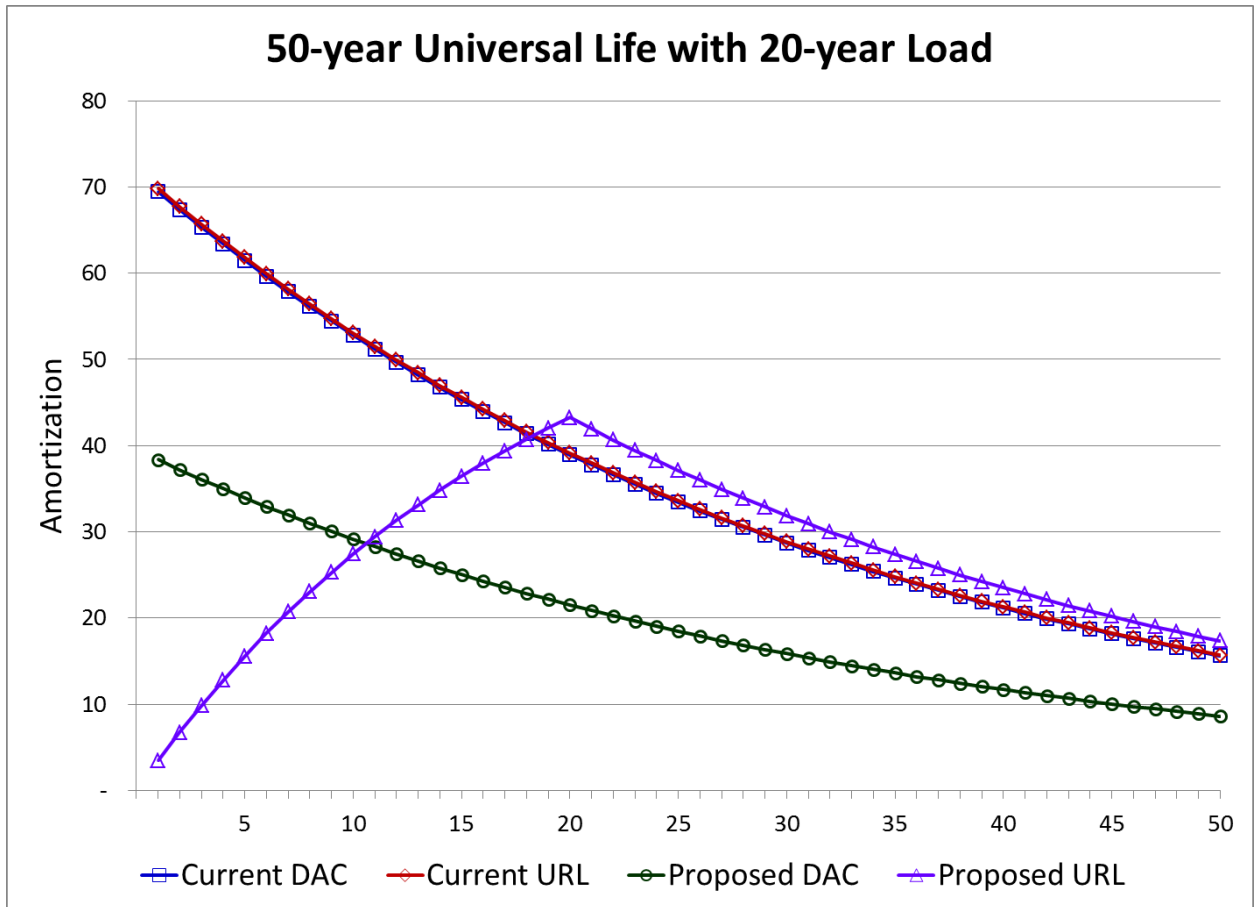
- The present value of front-end loads is \$1,005, nearly identical to the \$1,000 present value of acquisition costs.
- DAC and URL amortization will both be slightly below \$70 in the first year and will decline 3 percent per year along with the expected decline in the amount remaining in force.
- Implicit in this approach is the notion that all front-end loads must be aggregated to determine the portion of “compensation ... for services to be provided in future periods” rather than treating each load as independent of all others.

By retaining the link between URL and DAC amortization despite changes in DAC amortization standards, the proposed updates lose the mathematical equivalence of the two cash flows and with it the matching of expenses and revenue even while assuming they remain conceptually equivalent:

- With the \$1,000 expense incurred at inception but removing interest from the calculations, DAC amortization drops to \$38 in the first year. Again, amortization decreases 3 percent per year along with the expected decline in the amount remaining in force.
- Without discounting and by excluding expected future loads, URL will amortize just \$3.45 in the first year. The proposed updates will require deferring an additional amount each year in which another front-end load is charged. Thus amortization is \$6.73 in the second year, \$9.83 in the third year, \$12.78 in the fourth year, and so on until it becomes \$43.23 in year 20 and then declines 3 percent per year in later years.

- Implicit in this approach is the notion that the first \$90 includes “compensation ... for services to be provided in [49] future periods” but the last \$90 includes “compensation ... for services to be provided in [30] future periods”.

The effect of the change is apparent in this illustration of current standards (where DAC and URL amortization are nearly the same) and proposed updates (where DAC and URL amortization are radically different).



## Attachment II

### Term Insurance in Universal Form

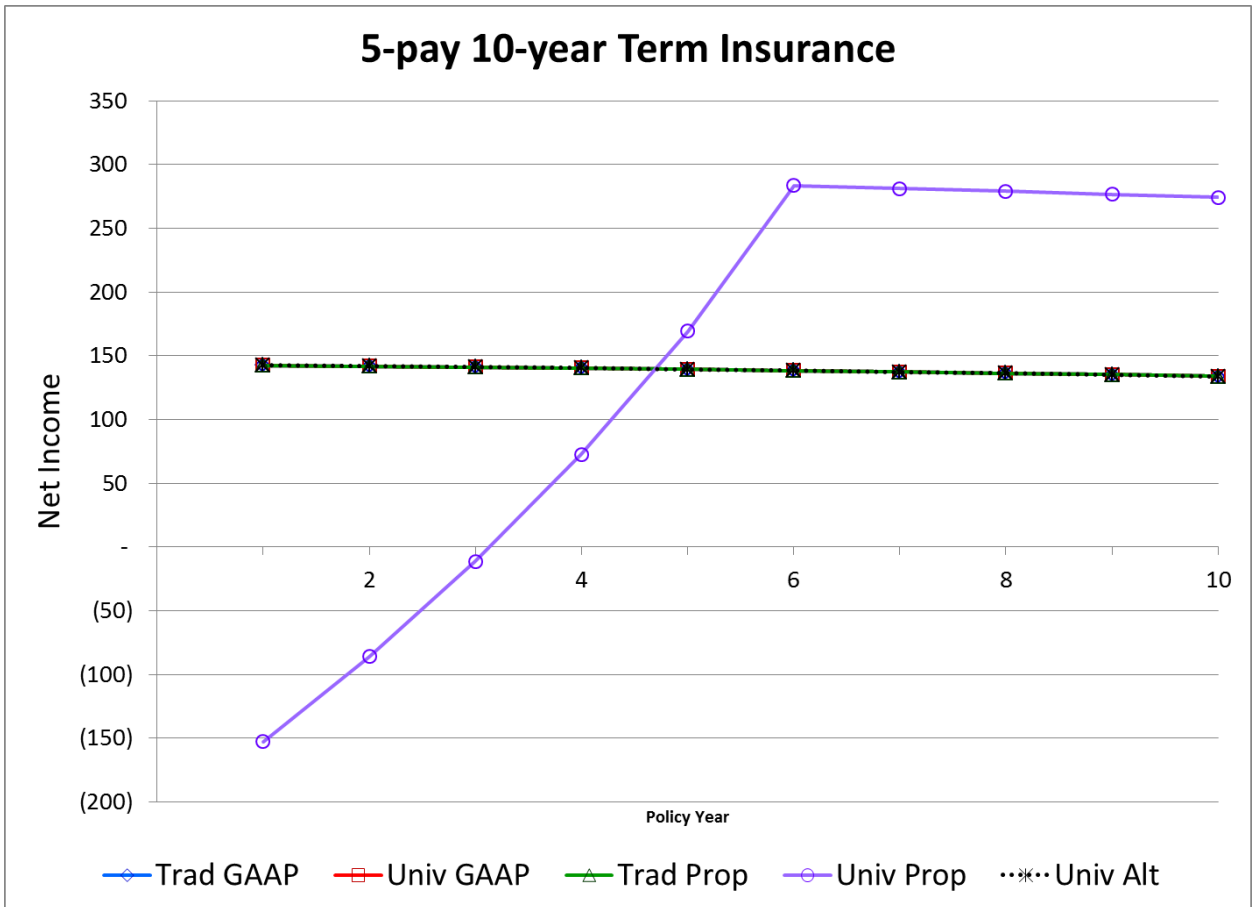
Though the 1987 board viewed front-end loads in two different ways, product design since then has made one of those views rather tenuous for many contracts. In our experience, front-end loads in universal life contracts are seldom designed as “consideration for origination of the contract.” More often, designs reflect instead the view that front-end loads serve as “compensation ... for services to be provided in future periods”.

Thus, in both design and function such front-end loads more closely resemble premiums of limited-pay contracts than acquisition costs. As such, revenues would be better matched to performance of the contract if their accounting were aligned with DPL rather than DAC.

The significance of the planned changes and our recommended alternative might best be understood by reviewing a hypothetical example of products whose form is different but whose economic substance is the same. Some universal life products have been designed over the past 20 years as a low-cost alternative to term insurance.

For a simple comparison across product forms and alternative accounting standards, consider a simple 5-pay 10-year term insurance contract and a universal life contract designed to mimic that term insurance. The economic substance of the two is same, though the form is clearly different. We believe that contracts with the same economic substance should have similar accounting results.

Assuming a 0 percent discount rate and removing provisions for adverse deviation (PAD), current standards produce the same result for both contracts, as shown in the next illustration. Also assuming a 0 percent discount rate, the proposed updates result in the same income pattern for the term insurance contract as the current standards. For the universal life contract, however, we see a radically different pattern under the draft standards. Aligning URL with DPL would restore the accounting equivalence for these two contracts that differ only in form.



Including non-zero interest and PAD where specified by current standards and the proposed updates would certainly produce some differences. Those differences, however, would be relatively insignificant and are not relevant to our current concern.