



November 10, 2009

Sir David Tweedie, Chairman  
International Accounting Standards Board  
30 Cannon Street, First Floor  
London EC4M 6XH  
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Dear Sir David:

We are disappointed with IASB's recent decision to calibrate initial margins on long duration insurance contracts to gross premiums without any reduction for incremental acquisition costs, reversing its prior decision to calibrate the initial margin to premiums net of incremental acquisition costs. As IASB is surely aware, this will cause insurance entities to show gains in periods when profitable sales fall and show losses in periods when profitable sales increase, a counterintuitive result that will reduce the usefulness and representational faithfulness of financial statements. But there are further reasons why we believe the recent decision was incorrect.

The decision was apparently made to achieve consistency between the revenue recognition project and the insurance contracts project. But, as we noted in our response to the Revenue Recognition discussion paper, we do not believe the revenue recognition project treats incremental acquisition costs correctly. We acknowledge that for the vast majority of customer contracts, the approach taken by the revenue recognition project works well. There are no such problems for short duration contracts; and for most long duration contracts, incremental acquisition costs are small relative to any revenues that will not be recognized for many years. But the approach does not work for contracts that have large up front incremental acquisition costs and significant revenue that is not recognized for many years. Long duration insurance contracts are an example of both situations. As such, we believe that an appropriate position for the revenue recognition project is to allow revenue (or some other form of income) to be recognized to the extent of incremental acquisition costs, as in the tentative position previously taken by the IASB in the insurance contracts project. Alternatively, the Boards could retain the existing position on revenue recognition, but acknowledge that while this position is appropriate for most contracts, contracts with up front incremental acquisition costs that are significant relative to long duration revenue need to follow a different approach, either within the revenue recognition standard or within a separate standard as allowed in the revenue recognition discussion paper.

This is the reason that the construction example noted by a board member at the joint meeting is not germane to the insurance contracts issue. While we do not profess to be experts in construction accounting, we believe that most construction contracts are of shorter duration than long duration insurance contracts. Also, we believe that the acquisition costs incurred by construction entities are primarily costs of developing bids. While these costs are incurred in the hopes of winning the contract, and perhaps in the expectation of winning at least some contracts, **most such costs are incurred whether or not any contracts are won.** As such, it is not inappropriate

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to expense those costs without any revenue offset.<sup>1</sup> However, **incremental insurance contract acquisition costs are incurred only if the contract is acquired.** In that way, they are the same as transaction costs on financial instruments.

Even if the Boards remain convinced that the handling of incremental acquisition costs within the customer consideration model used for revenue recognition is appropriate, insurance contracts remain different. The Boards acknowledge that insurance contracts are different by virtue of pursuing a separate project specific to insurance contracts. If the customer consideration model is appropriate for insurance contracts, the Boards could save themselves a lot of scarce time and resources by scrapping the insurance contracts project and simply including insurance contracts within the revenue recognition project.

However, the Boards have concluded that the customer consideration model, which is an allocated premium model, is not appropriate for valuing insurance contract liabilities. Rather, the Boards have concluded that a “current value” measure of the obligation is the appropriate model for valuing insurance contracts. Although the IASB and FASB have not agreed on a specific model for insurance contracts, neither position is to use a customer consideration model to value insurance contracts.

Having decided that a current value model is appropriate for insurance contracts, **calibrating the liability to gross premiums before any reduction for incremental acquisition costs is inconsistent with a current value model.** Calibrating the liability in such a manner means that an insurance entity is effectively holding a liability for costs that have already been incurred and paid, i.e., the incremental acquisition costs. A current value model should only incur a liability for future costs not yet incurred or paid.

Under a current value model, a calibrated residual margin after calculating the present value of future cash flows and any uncertainty adjustment or risk margin<sup>2</sup> is justified to avoid a gain at inception of a contract due to measurement imperfections. And calibrating a residual margin in this manner is appropriate, because **the best observable estimate of the current value of the liability immediately after inception is the premium net of the relevant acquisition costs.** But if the initial liability is calibrated to gross premium before a reduction for incremental acquisition costs, the residual margin will not merely reflect small measurement imperfections. Rather, the residual margin will be large, essentially adding the incremental acquisition costs back to the calculated current value of the liability. In other contexts IASB seems to recognize that such costs should not be part of a current value measurement, since paragraph 11 of the “Financial Instruments: Classification and Measurement” exposure draft does not add back transaction costs to the current value of financial assets and liabilities that are measured at current value (in that case, fair value is the current value measure used).

As an example, assume a contract with a premium of CU1000 and incremental acquisition costs of CU450. For such a contract, it would not be unreasonable to have a present value of expected future cash flows at inception of CU500 and a calculated risk margin at inception of CU30. Assuming no service margin, an appropriate residual

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<sup>1</sup> Other types of contracts have also been brought up in comparison with insurance contracts. None of these contracts have the characteristics that make insurance contracts problematic under the revenue recognition model. For example, cell phone contracts have a much shorter duration than insurance contracts, and the up front costs in the form of free cell phones or other incentives are much smaller. Hence, it may well not be worth the trouble for telecommunications entities to recognize revenue for the free cell phones. The amount is small and the revenue will be recognized over a short period anyway. Another example we have heard raised is auto manufacturing, due to cars being sold at a loss with the expectation of earning profit on warranties and other ancillary services. But the revenue recognition model allocates revenue based on performance obligations, not margins. Therefore, the auto manufacturer still recognizes a large portion of the revenue in the contract at the point of sale, and the remainder of the revenue is recognized over a much shorter period than many insurance contracts.

<sup>2</sup> This would also include any service margins as well. Even if no explicit risk margin, service margin or uncertainty adjustment is required, the calibrated composite margin should not be significantly larger than the calculated risk margin, service margin or uncertainty adjustment would have been.

margin would be CU20, avoiding a gain at inception and appropriately reflecting any measurement or market imperfections.

But if the initial liability is calibrated to the gross premium before incremental acquisition costs, the residual margin in this example would be CU470, almost as large as the present value of expected future cash flows. Indeed, for many insurance contracts the residual margin thus calculated will be greater than the present value of expected future cash flows.

At the joint meeting, one board member asked a valid question in support of using the revenue recognition approach. She used the example of an internet sale with a low premium versus an agent sale with a high premium due to higher incremental acquisition costs. She asked why those two contracts should show a different amount of revenue at inception. But let's assume that the internet premium is CU100 and the agency premium is CU110 due to a CU10 difference in incremental acquisition costs, and the contracts are otherwise identical. Once the premiums have been collected and the acquisition costs paid, why should the two contracts show different liabilities, especially under a current value model? **The future obligation under both contracts is identical, so should the current value of the liability.** It is true that recognizing revenue (or some other gain) for incremental acquisition costs will cause a difference at inception in the amount of revenue recognized, in this example CU10. But no matter what method is used, **over time the two contracts will generate different revenue amounts** – the internet contract will generate a total of CU100 of revenue and the agency contract will generate CU110. So there is no need to distort the current value of the liability to maintain consistency in revenue recognition at inception when that consistency will erode over time anyway.

We note one additional perverse effect of calibrating liabilities at inception to the gross premium before incremental acquisition costs. In the United States, financial statements used for regulatory purposes differ from the general purpose financial statements reported under GAAP. The regulatory financial statements intentionally use a conservative accounting basis, in order to insure solvency. However, even this regulatory accounting basis makes some allowance for acquisition costs – not to the extent of DAC under current US GAAP but an allowance nonetheless. If GAAP liabilities are calibrated to gross premium without any allowance for incremental acquisition costs, GAAP liabilities will actually be more conservative than statutory liabilities.<sup>3</sup>

Sincerely,

A handwritten signature in black ink that reads 'Kevin Spataro'. The signature is written in a cursive, slightly slanted style.

Kevin Spataro  
Chairman, GNAIE Accounting Convergence Committee

KAS:LR:c11

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<sup>3</sup> This is also the answer to the comments made at the joint meeting about insurers possibly having DAC in excess of total equity. That is not necessarily a problem because the basic GAAP reserve before DAC is often overly conservative, and often more conservative than the regulatory reserve. However, the GAAP reserve net of DAC generally provides an appropriate estimate of the liability, one which is lower than the regulatory reserve. That the GAAP reserve before DAC is conservative can be demonstrated that the GAAP reserve net of DAC must be adequate under the premium deficiency test of FAS 60; since the GAAP reserve net of DAC is adequate, the GAAP reserve before DAC must be more than adequate. In addition, the regulatory reserve, which is often lower than the GAAP reserve alone, must pass reserve adequacy testing under regulatory requirements.