



July 2, 2009

Mr. Marc A. Siegel
Member, Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856

RE: Insurance Acquisition Costs

Dear Mr. Siegel:

During the Insurance Working Group meeting earlier this week, Leslie Seidman mentioned that you are now performing the valiant task of “collaborator” for the FASB with the insurance industry – following in the footsteps of Mike Crooch. It is with that understanding that we are writing to you today.

The FASB’s tentative conclusion regarding acquisition costs for insurance contracts has the potential to create severe accounting mismatches of revenue and expenses, especially for long duration contracts, which could result in financial information that is seriously misleading. According to that position, reached on May 18, the issuer of an insurance contract would be required to expense acquisition costs when incurred, but would not be allowed to recognize revenue at that time. As you know, this is different than the tentative conclusion reached by the IASB at its April meeting. They would allow revenue to be recognized at inception to offset the acquisition costs that are expensed at that time.

Acquisition cost issues can be addressed in many ways that would not result in misleading financial information, including the approach on which the IASB has tentatively decided.

- A. Attachment A to this letter contains a listing of several ideas that might be considered, and also contains a list of issues/questions related to acquisition costs that should be addressed in the accounting standard for insurance contracts.
- B. Attachment B is a simplified numerical example that might be useful as background for further discussion of these issues. At the end of Attachment B, there is a summary list of conditions that, if met, might allow for implementation of the approach advocated by the FASB without mismatch of revenue and expenses related to acquisition costs.

Jerry M. de St. Paer
Executive Chair

Douglas Wm. Barnert
Executive Director

Group of North American Insurance Enterprises
40 Exchange Place, Suite 1707
New York, NY 10005
UNITED STATES

++1-212-480-0808
info@gnaie.net
www.gnaie.net

Insurers fully consider acquisition costs when they price insurance contracts, including their long duration contracts. These prices provide for recovery of the acquisition costs. It is not decision useful to create an accounting standard which would require insurers to report losses on the sale of contracts that are expected to be profitable, with those expectations often based on long and very credible experience. With such a standard, insurers might be required to report substantial losses as a result of increased sales of profitable business, or substantial gains as a result of declines in sales of profitable business. These are not logical outcomes.

Many insurance contracts (especially for life insurance) extend for much longer periods of time than is the case for most other customer contracts. For most other contracts, the revenue needed to cover acquisition costs is recognized over a relatively short period of time. The acquisition costs for long duration insurance contracts can be quite high relative to the revenue that is actually received in the early contract years. Furthermore, a large portion of the acquisition cost for insurance contracts is paid as a direct result of acquiring the contracts. This is different from industries in which there are high up front development costs, which are incurred whether or not contracts are actually sold. In these cases, a loss is incurred by the company if no contracts are actually sold. But for insurance, the bulk of the acquisition cost is incurred only if contracts (which are generally expected to be profitable) are actually sold.

We would be very happy to work with the FASB on solutions that would not result in misleading results, and that could resolve differences in the positions of the FASB and the IASB regarding treatment of insurance acquisition costs.

Sincerely,

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

Kevin A. Spataro
Chairman, GNAIE Accounting Convergence Committee

KAS:KK:c11

cc: Leslie Seidman, Member, FASB
Jeffrey Cropsey, Project Manager, FASB
Mark Trench, Project Manager, FASB
Hans van der Veen, Practice Fellow, IASB

Attachment A

**Approaches for Treatment of Revenue and Expenses
that might not result in accounting mismatches at inception**

- 1) Acquisition costs are expensed as incurred/paid, and sufficient revenue is recognized at inception of the contract to cover these costs. The contract is then subject to loss recognition testing, and the contract liability is adjusted if necessary if there is an expected loss. This approach is consistent with the tentative decision reached by the IASB in April 2009.
- 2) Similar to #1 above, but acquisition is considered to be a separate performance obligation under an insurance contract. We don't advocate this approach, because we believe that the only performance obligation under an insurance contract should be providing risk protection to the insured, and all other services performed by and for the insurer are ancillary to performance of that obligation.
- 3) Defer acquisition costs, because these costs are incurred to put in place a long duration contract, and recognize the costs as the insurer provides risk protection to the insured under the contract. With this approach, contracts would be tested at each reporting date for recoverability of deferred costs, and costs that are no longer expected to be recoverable could no longer be deferred.
- 4) The acquisition costs could be considered to create a customer relationship asset, or other form of intangible asset, which would be written off as risk protection is provided under the contract.

Issues Related to Acquisition Costs

- 1) Which costs are considered to be acquisition costs? The IASB position is that the acquisition costs are incremental costs incurred at inception that would not have been incurred if the contract had not been issued.
- 2) To what extent is recoverability of the acquisition costs considered in determining when such costs are recognized? Some incremental costs incurred at inception are recoverable if the contract is cancelled within a certain time before the end of the contract period.
- 3) Both the FASB and the IASB have taken the position that a gain should not be recognized at inception of an insurance contract, and that gains resulting from such contracts are to be recognized as the insurer provides risk protection under the contract. Is determination of whether there is a gain at inception made before or after the acquisition costs are recognized? See the numerical example in Attachment B for clarification of this question. This matter is resolved if an equal amount of revenue and expense is recognized at inception, and thus there would be no loss at inception due to acquisition costs.

Attachment B

**Simplified Numerical Example of Acquisition Costs
for a long duration insurance contract**

The time value of money is not considered in this simplified numerical example, and the only margin considered is the amount necessary to eliminate what would otherwise be a gain at inception. Consider a 10 year life insurance contract, for which the premium at inception is \$1000, acquisition costs incurred at inception are \$700, and the expected (probability weighted) value of subsequent cash flows are \$6000 for premium, \$5000 for policy benefits (including \$1000 of policy benefits that are not guaranteed), and \$800 for (non-acquisition) expenses. In order to eliminate a gain at inception, the initial margin would be \$500 if all expected premiums and benefits are considered and the “no gain at inception” condition includes the acquisition cost ($7000 - 5000 - 800 - 700 = 500$); and would be \$1200 if the “no gain at inception” condition is determined without considering (i.e., after) the acquisition costs that are expensed at inception ($7000 - 5000 - 800 = 1200$). In the example that follows, the initial margin is assumed to be \$500, and it is released uniformly over the 10 year contract period. The premium, benefits, and non-acquisition costs in this example are also assumed to be recognized uniformly over the contract period.

Based on the FASB’s position (tentative conclusion reached on 5/18/09):

The liability value at the end of the first year would be \$(630) (based on remaining cash flows to recognized of \$6300 of premium, \$4500 of benefits, \$720 of expenses; and \$450 of margin yet to be released) ($4500 + 720 + 450 - 6300 = (630)$). For the first year, the insurer would recognize expenses totaling \$780 (\$700 of acquisition costs and \$80 of other expenses), benefit costs of \$500, revenue of \$700, and margin of \$50 would be released. If the insurer is allowed to carry a negative liability of \$(630) at the end of the first year, it would recognize a net profit of \$50 for the year (revenue of \$700 – increase in reserve of \$(630) - \$500 benefits - \$780 expenses = \$50). If the negative reserve is not allowed (i.e., if the reserve is not allowed to be less than zero), the insurer would realize a loss of \$580 for the year ($700 - 500 - 780 = (580)$).

The reserve would increase by \$70 in each of the nine subsequent years, remaining negative throughout the contract period and reaching zero at the end of the tenth year. Also in each year, \$700 of revenue, \$500 of benefits, and \$80 of expenses would be recognized. If negative reserve liabilities are allowed, the insurer would show a net profit of \$50 in each year ($700 - 70 - 500 - 80 = 50$). If the reserve is not allowed to be negative, the profit in each year after the first would be \$120 ($700 - 500 - 80 = 120$), following the loss of \$580 in the first year.

Based on the IASB’s position (tentative conclusion reached at its meeting in April 2009):

At inception, \$700 of revenue and the \$700 of acquisition costs would be recognized. The expected cash flows to be recognized after inception are \$6300 of premium, \$5000 of benefits, and \$800 of non-acquisition expenses. Assume an initial margin of \$500 (that would eliminate the gain at

inception that would occur if there were no margin), to be released uniformly over the 10 year contract period. The liability value at the end of the first year would be \$0 (based on remaining cash flows to be recognized of \$5670 of premium, \$4500 of benefits, and \$720 of expenses; and \$450 of margin yet to be released) ($4500 + 720 + 450 - 5670 = 0$). The insurer would report a profit of \$50 for the first year (based on revenue of \$1330 ($700 + 630$) and total costs of 1280 ($700 + 500 + 80$), and no change in reserve during the year (reserve is 0 at inception and 0 at the end of the first year). In each subsequent year, revenue is \$630, total costs are \$580, \$50 of margin is released, the end of year reserve liability remains at \$0, and the net income is \$50 ($630 - 580$).

As indicated in this simplified example, the FASB's position could result in matching of income and expenses if the following conditions are met.

- 1) Reserve liabilities are allowed to be negative, perhaps for the entire contract period.
- 2) In the condition of no "gain at inception", the absence of a gain is defined to include the acquisition costs that are expensed at inception of the contract.
- 3) All expected premiums are included in the cash flows used to determine the liability, including expected cash flows that are dependent on policyholder behavior.
- 4) All expected policy benefits are included in the cash flows used to determine the liability, including policy benefits that are expected but not guaranteed in the contract.