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Sir David Tweedie, Chair
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH, United Kingdom

Mr. Robert H. Herz, Chair
Financial Accounting Standards Board
401 Merrit 7
Norwalk, CT 06856-5116

Re: Insurance Contracts – Acquisition Costs for the Life Insurance Industry

Dear Sir David and Bob Herz:

The American Council of Life Insurers (ACLI)¹ is pleased to share with you our views regarding the issues related to deferred acquisition costs (DAC), which was recently discussed at the October 2009 joint IASB/FASB meeting. Prior to this meeting, the IASB had tentatively decided to recognize in revenue part of the customer consideration to serve as an offset to expensed acquisition costs. The FASB's expressed view is that acquisition costs should be expensed, consistent with the IASB position, but that no specific offset should be recognized in revenue. During the joint meeting, the IASB reversed its tentative decision agreeing that the insurance contracts exposure draft should present a single view on DAC and that view would reflect the FASB's position.

The purpose of this letter is to provide a discussion of the business reasons driving the life insurance industry's practice of paying insurance agents commissions to sell life insurance products. We would like to provide the Boards with an understanding of why the insurance industry pays acquisition costs upfront and an appreciation for the financial statement implications of expensing those acquisition costs through the income statement on a pay-as-you-go basis.

Finally, we would like to offer a discussion of three potential solutions for the Boards' consideration and offer our assistance in reaching toward a solution within the converged insurance contract standard:

- 1) Record DAC as an intangible asset
- 2) Establish an Asset for Underlying Contract Value
- 3) Include Recovery of Distribution Expenses in Insurance Liability Measurement.

Payment of Upfront Agent Commissions Discussion

Insurance companies typically pay insurance agent commissions upfront when the business is sold to compensate the agent for the relationship that the agent has developed. During the process of initiating an insurance sale, the insurance agent develops the initial relationship with the customer. Due to the relationship that agent and customer develop through the sales process, the agent delivers to the insurance company the ability to realize future profits on the business that was sold. When the insurance agent sells a policy, services that policy and then delivers the relationship with that

¹ The American Council of Life Insurers represents 340 member companies operating in the United States, of which 332 are legal reserve life insurance companies, and 8 are fraternal benefit societies. These member companies account for 93% of total life insurance company assets, 94% of the life insurance premiums, and 94% of annuity considerations in the United States.

customer to the insurance company to maintain over the remaining life of the policy, the agent has performed a service for the company that will ultimately translate into future profits for the insurance company. Depending on the type of product that was sold, this profit may emerge through different forms of future cash flow streams, but the concept of the agent providing the insurance company with the customer relationship remains consistent.

In order to compensate the agent for the service performed during the sale, the insurance company pays the agent commission upfront when the policy is placed. The commissions are paid upfront instead of level throughout the contract life due to the insurance company's business objective to have the agent focused on selling new business. The service provided by the agent is focused on securing the sale and servicing the sale, while the insurance company provides the continued maintenance and support throughout the remainder of the policy. Heaped commissions paid when business is sold serve a business purpose by agent incentives to increase sales production and generate new sales.

The business purpose for compensating agents in conjunction with securing a sale is the reason why insurance companies pay commissions upfront, not the ability under current US GAAP to defer the expense of these payments on the company's income statement. If acquisition costs were no longer permitted to be deferred, the practice of paying commissions would not change because the business case for compensating agents upfront has not changed.

Financial Statement Implications of Expensing Acquisition Costs

We believe that as part of exploring a solution to the treatment of acquisition costs in conjunction with the insurance contracts project, the Boards should also consider the decision-useful impact to the financial statements if acquisition costs are expensed when paid. This situation facing the insurance industry is not completely dissimilar to other industries such as the banking industry, where loan origination costs are capitalized under current US GAAP in order to maintain the decision-usefulness of the financial statement impact from making an investment in new business. As you are aware, expensing acquisition costs without an offset will produce a loss at inception and create volatile income statement results. Volatility alone, however, does not impede the decision-usefulness of an insurance company's financial statements. We believe that the impact from expensing acquisition costs creates misleading, uneconomic results which will impede the decision-usefulness of the information as they will not represent a meaningful reflection on the performance of the company during the financial reporting period.

Insurance sales are cyclical, with peaks and valleys that tend to follow broad economic cycles. For example, interest rates and equity market performance can significantly influence fixed annuity and variable annuity sales. Life insurance sales rise and fall in line with many other macro economic indicators. While the industry's sales tend to experience volatility due to these factors, they do not under current GAAP result in corresponding volatility in earnings. We believe that this is a proper reflection of the broad economics of our business due to the long term nature of our products. Sales alone should not lead to income statement volatility. Volatility, though, is a reality in our business. That volatility is usually created from investment activities or reserving changes. Our concern, therefore, is not that expensing acquisition costs leads to volatility, but rather, it will lead to volatility that does not reflect a meaningful reflection on the performance of the company during the financial reporting period.

If the Boards pursue a model for treating acquisition costs as expenses (without considerations for other possible compensating solutions as described in the next section), an insurance company will experience a significant deterioration in earnings during periods of high sales activity. The upfront payment of commissions will lead to large losses. This result is counter-intuitive and impedes the decision-usefulness of the financial statements. We believe that the analyst community and other financial statement users will rely on non-GAAP financial performance measures that are a significant departure from the GAAP income statement in which the acquisition costs are expensed. As such, we

recommend that the Boards work to move toward a resolution to this issue as they continue their joint deliberations. We continue to stress that the financial statements of insurance companies need to present fairly and accurately the performance of the company during the period being presented and not just in the period of sale. Volatility due to investment losses or reserve changes are generally real and should be presented, however recording financial statement losses while originating profitable business is misleading and fails to recognize the overall economics of our business. What will result are artificially depressed earnings during periods of high sales with artificially high earnings to follow.

Discussion of Potential Solutions/Paths to Consider

In our response to the Discussion Paper, *Preliminary Views on Insurance Contracts*, questions, we answered the question “**Should an insurer recognize acquisition costs as an expense when incurred? Why or why not?**” as follows:

“We agree with the Board’s preliminary view that acquisition costs should be expensed as incurred as long as the proposed model does not place artificial limits on the premiums that should be reflected in the liability calculation.”

We believe that there are multiple paths that the Boards could pursue to address the issues we have discussed in this letter. We understand and appreciate the fact that the Boards’ tentative conclusions about the measurement of insurance contract liabilities have resulted in part from the alignment of the insurance contracts project with the revenue recognition project. The contract with the customer is the contract between the insurer and the policyholder, not with the agent. Therefore, the payment of agent commissions would represent a separate contract between the insurance company and the agent. We are not automatically suggesting that a solution to the industry’s issue would result in an inconsistent application of the revenue recognition standard, but we feel that it is important that the Boards work to address the issue from a holistic standpoint so as not to devalue the usefulness of an insurance company’s financial statement. Outlined below are a few potential paths that the Boards may wish to consider as they work through this issue; we would welcome the opportunity to further discuss any of these potential options with the Boards in further detail:

1. Record DAC as an Intangible Asset

In this model, the consideration paid to the agent is a proxy for the generation of future profits from the business. The benefit of this model is that it would pass the asset test by starting with a tangible business expense that represents the consideration for future cash flows. We believe that while not precise, the commission paid to acquire new business is generally in line with the future value of the business acquired. As such, it is an asset in that it will provide future earnings for the company and it has value, albeit not exact, in the event of a business combination. A challenge with this model would be the treatment of acquisition costs for the same products sold through different distribution channels, i.e. captive agents vs. internet. This model, similar to U.S. GAAP today, results in different treatment for direct versus indirect expenses.

2. Establish an Asset for Underlying Contract Value

In this model, the asset is not dependent on the acquisition costs incurred and expense, but rather is determined based on the value of the underlying contract. This model is similar to the existing process for determining the asset representing the value of the acquired business in US GAAP purchase accounting. While this is an asset created by the Company, it is not internally generated as the customer contract is normally acquired from an external distribution channel. This model is not dependent on the type of distribution that the business is sold through, which would potentially make it favorable to option 1 described above. However, there may be issues of day 1 gain/loss recognition as the recorded asset would not equal the expense incurred to acquire the business.

3. Include Recovery of Distribution Expenses in Insurance Liability Measurement

This model is similar in concept to the IASB model through which there is an offset in revenue except that the present value of cash flows to recover the acquisition costs are measured through the liability. The insurance contract liability at inception for profitable contracts would result in a \$0 gain at issue. However, this could, in many cases, produce a negative liability in the early years of the contract due to timing differences between the period when costs are incurred and recovery of the costs, which may present some presentational issues.

As indicated above, each of the solutions presents challenges for the Boards to address within the standard setting process. While there is potentially not a perfect solution to the issue of accounting for acquisition costs, we believe that any and all of the above solutions are far superior to the tentative conclusion of the Boards to just expense them as incurred.

Thank you for the opportunity to express our views on this important issue. We encourage the Boards to consider our observations and recommendations contained in this letter as they deliberate issues such as DAC and other components of the measurement of insurance contract liabilities, and welcome the opportunity to discuss these points in further detail.

Sincerely,

A handwritten signature in cursive script, appearing to read "M. Morahan".

Cc: Peter Clark, IASB staff
Hans van der Veen, IASB staff
Jeffrey Cropsey, FASB staff
Mark Trench, FASB staff