



# AMERICAN ACADEMY *of* ACTUARIES

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Sir David Tweedie  
International Accounting Standards Board  
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Dear Sirs:

The Financial Reporting Committee of the American Academy of Actuaries<sup>1</sup> has been monitoring the activities of the Boards' joint Insurance Contracts project with great interest. We look forward to providing comprehensive input to the Boards later this year via the normal exposure and comment process. Nevertheless, we would like to comment now on the recent vote by the IASB and confirmation by the FASB to not permit the recognition of revenue for incremental acquisition expenses upon the initial measurement of an insurance contract.

We understand from recent discussion of the Boards that the current proposal is to calibrate the contract value to premium at inception without recognizing revenue for incremental acquisition costs. We are concerned that, as a result, a loss equal to the acquisition costs would be recorded at inception for every single contract written, which clearly does not faithfully represent the economic value of the contracts.

We believe that any way of accounting for insurance contracts that forces recognition of a loss at inception due to the occurrence of acquisition costs reduces the usefulness and transparency of the information presented in the financial statements. We further believe it may have an adverse effect on the availability and price of insurance contracts.

As an alternative, we recommend that any calibrated margin, whether a residual margin or a composite margin, should be calibrated to the premium at inception net of incremental acquisition costs. We believe that the resulting liability value will provide the most faithful representation of the economic value of the insurer's obligation under the contracts.

In the attached pages we provide additional discussion of our concerns. We thank you for your attention to this important matter.

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<sup>1</sup> The American Academy of Actuaries ("Academy") is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers 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.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Rowen B. Bell". The signature is written in a cursive style with a large, prominent loop at the end of the last name.

Rowen B. Bell  
Chair, Financial Reporting Committee  
Risk Management and Financial Reporting Council  
American Academy of Actuaries

## Our Concerns

There are several reasons why we believe that acquisition expenses should not normally contribute to losses at inception of a contract:

1. Both FASB and IASB have agreed that the measurement attribute for insurance contracts should be a form of current value. The recent vote to calibrate the liability at inception to the gross premium, when combined with current considerations for the valuation of insurance contracts, violates this attribute. Even in a competitive insurance market the premiums for an insurance contract normally include sufficient provision for recovery of acquisition costs, in addition to the provision for expected obligations and risk margins. To ignore acquisition costs when calibrating margins (residual or composite) to price is, in effect, to attribute part of the premium to the future costs when those costs were actually incurred in the past. Therefore, the current value of the insurer's obligation to the policyholder at inception of the contract is best represented by the premium net of the incremental acquisition costs. That is the amount at inception that represents future, rather than past, obligations.
2. In the joint financial instruments project, the IASB exposure draft *Financial Instruments: Amortised Cost and Impairment* would produce an initial liability equal to the consideration net of transaction costs for financial instrument liabilities held at amortized cost (§5). A financial instrument liability held at fair value (even if modified for own credit standing) would not be explicitly adjusted for transaction costs, but the fair value would incorporate the future margins intended to recover any transaction costs, appropriately reducing the liability value. We believe this treatment of financial instrument transaction costs is correct, and we do not see any reason why the similar incremental acquisition costs incurred for insurance contract liabilities should be treated inconsistently. Having insurance contract liabilities effectively grossed up to the extent of incremental acquisition costs would place tremendous pressure on the dividing line between an insurance contract and a financial instrument. This is hardly a merely academic concern, since many insurance contracts contain elements similar to a financial instrument. Even today, subtle differences in the definition of insurance contracts between IFRS and US GAAP cause some products to be treated as insurance contracts under one set of standards but as investment contracts under the other.
3. Decades ago, when US companies issued financial statements only on a regulatory (statutory) accounting basis, there was limited relief from high acquisition costs. Entering into new contracts caused life and health insurance companies to report losses, even though the business was widely recognized as profitable. The more successful a company was in selling life and health insurance, the greater the losses appeared in its financial statements. Acknowledging this, analysts kept their own set of financial statements to better reflect the value of the business. Analysts developed "adjusted earnings" which were computed according to their own set of rules to better address acquisition costs and to reflect performance for the period. These "adjusted earnings" calculations were often published and eagerly awaited by the industry. If general purpose accounting (GAAP and IFRS) reverts to a standard that forces reporting of losses at inception, it is likely that analysts and other users will again see a need to maintain their own set of adjustments to

better reflect the economics of the business. In short, the published statements would fail to be decision-useful.

4. This type of accounting may affect the types of products being offered. Company management is charged with increasing the value of the company—issuing profitable insurance policies. Yet, causing losses purely by the accounting treatment will reduce market competition as losses at inception will make it more difficult for companies to grow their business or enter into new markets. Other possible consequences include: products being withdrawn; disruptive attempts to move agents to level commissions; or the development of new investment bank structuring transactions to make the accounting match the economics.
5. An insurance contract has high upfront costs that are incurred only if the contract is entered into by the relevant parties. These are not merely the costs of developing a bid, which are incurred whether or not the contract is won and can be viewed similarly to other ongoing expenses. These obligations to pay incremental acquisition costs are identified and separately incorporated in pricing when entering into the contract. If the revenue to fund these costs is deferred, users of the financial statements would have to offset the deferred amounts against the losses at inception to make meaningful decisions.
6. Respondents to the IASB's *Preliminary Views on Insurance Contracts* were gravely concerned about the emergence of profit at the point of issue, which would paint an inappropriate picture of revenue. The Board eventually concurred and proposed methods to eliminate profits at issue. But it is equally problematic to report losses at issue on contracts that are expected to generate positive economic value.

## **Discussion of the Issues**

Acquisition costs are sufficiently endemic to the business of insurance that even an established carrier with the right portfolio of products cannot avoid a significant cost to issue a new contract, or to replace an existing contract of another carrier. As such, premiums for insurance contracts are normally sufficient to compensate the issuing entity for recovery of its acquisition costs, in addition to its expected cost of future benefit obligations and any adjustment for risk inherent in the uncertainty of the business.

Evidence of this also exists in the market for portfolios of insurance contracts. Although this is not an active market, there has been sufficient trading of insurance portfolios, through acquisitions and assumption reinsurance, to demonstrate that entities are willing to pay a price to acquire a portfolio of insurance contracts.

One would expect that, immediately after issue in a competitive market, an insurance contract would represent an asset to the issuing entity in an amount that is approximately equal to the acquisition costs associated with the contract, minus the amount of premium collected at inception. Or, in the case of a contract requiring a substantial premium payment at inception, the liability value attributed to the contract would be less than that premium by an amount approximately equal to the acquisition costs associated with the contract.

Both the IASB and the FASB have repeatedly expressed a preference for there to be no gain reported at issuance of an insurance contract. This makes sense for a competitively priced product in a competitive market. Although an entity can attempt to sell a more heavily priced product, and may even succeed in making that sale, such a product should be expected to face increased risk of termination when the customer is presented with an opportunity to purchase a more competitively priced product. That increased risk should be reflected in an increase to the liability, such that there is no gain reported at issue. (We do not consider, here, the possibility of a market that is not competitive.) Conversely, a product priced below the market cannot normally expect performance sufficiently favorable to offset the price difference. A loss at inception thus becomes possible for a product priced below the market. (We do not consider this situation any further in this discussion.)

Whether a residual margin is used or whether a composite margin is used, the “no gain at issue” problem is solved by a margin calibrating to premium at inception. Looking at an approach with explicit margins, where the calibration is done in a residual margin, we should expect that the residual margin is small. In essence, a residual margin represents the difference (at issue) between a market price and a discounted estimate of market value based on expected cash flows and risk adjustments. If the discounted estimate is a good estimate, then any residual margin should be small. If it is not small, then either the price is not a competitive market price or the estimate of value based on cash flows and risk margins is of poor quality.

Since a competitive insurance price normally includes provision for recovery of acquisition costs, the residual margin will not be small if acquisition costs are not included in the calibration. To better reflect the economics of the business, and the reality of a competitive insurance market, any calibration to price should include acquisition costs. Under most circumstances, this will result in an entity reporting no gain at the inception of an insurance contract and, unless the premium collected at inception is greater than the acquisition cost, the value attributed to a new insurance contract should be an asset.

Finally, we return to the statistical reality that the value of insurance contracts can be reliably measured only in aggregate. Pooling of risk is, after all, a fundamental underpinning of the concept of insurance; as such, an issuer of insurance contracts will typically assess performance not at the level of an individual contract but rather at a block of business level. Although entities holding such contracts may value a block of business in the aggregate by calculating amounts for each contract, the portfolio must be aggregated for reliable measurement. In this effort, it should make no difference whether an asset value or a liability value is attributed to each individual contract; the entire portfolio of insurance contracts should be aggregated in determining the amount of an asset or a liability that the entity has for insurance in force.

Subsequent valuations of insurance contracts will largely represent a current value of the difference between an entity’s rights and obligations. Only the estimation error, as reflected in the calibration, would be a remnant of valuation at inception.

## **Our Recommendation**

Any calibrated margin, whether a residual margin or a composite margin, should be calibrated to

the premium at inception net of incremental acquisition costs. We believe that the resulting liability value will provide the most faithful representation of the economic value of the insurer's obligation under the contracts.

We do not offer a recommendation as to how the adjustment for incremental acquisition costs should be presented in the statement of financial performance. Recognizing revenue to the extent of incremental acquisition costs would be a straightforward approach. However, recognizing the adjustment through some other form of income or another income statement line would also produce a reliable and faithful presentation of the financial statements.

We thank you for your attention to this important matter. If you have any questions, please contact Tina Getachew, senior policy analyst, Risk Management and Financial Reporting Council, by phone (+1 202/332-5958) or email ([getachew@actuary.org](mailto:getachew@actuary.org)).