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Don't Miss This Second Chance

The Proposed DAC on Internal Replacement SOP to Re-emerge Soon

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Editor's Note: This article was written in August 2004. Some events it anticipates as occurring in the future may already be in the past on the publication date.

It is not often that one is given a second chance. But if all goes according to current plans, actuaries and other insurance professionals will be given a second chance later this year. At its July meeting, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants (AcSEC) voted, among other things, to re-expose the current draft of the SOP: Accounting by Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other than Those Specifically Described in FASB 97 (DAC for Internal Replacements SOP or SOP). Although it is unusual for the AcSEC to re-expose a document, given the significant changes that occurred since the March 2003 exposure draft, AcSEC decided a limited new exposure was appropriate. However, it will be a limited exposure, having occurred in October or early November. This will be an opportunity for actuaries to take advantage of a rare second chance.

Background of Proposed SOP

If this SOP is new to you, you may be interested in knowing that the AcSEC has been working on this project since 1999. The guidance in the SOP originated with that which is provided in EITF 96-19 Debtor's Accounting for a Modification or Exchange of Debt Instruments. EITF 96-19 provides that substantive modifications of debt, based on a quantitative measure, should be accounted for as the extinguishment of that debt and the creation of new debt. Copies of EITF 96-19 can be found on the FASB's Web site at *http://www.fasb.org/public/* for a small fee, or you can ask your company's public accounting firm to borrow their copy.

The DAC for Internal Replacement SOP uses this underlying principle to provide that substantial changes to an insurance contract, based on a qualitative measure, should be treated as an extinguishment of the original contract and the issuance of a new contract. The AcSEC considered a quantitative test similar to what is used in EITF 96-19 for debt instruments. However, the AcSEC concluded that a quantitative test is not acceptable because of the complex nature of insurance contracts and the potential for manipulation due to the subjectivity of assumptions required to perform such a test. For non-substantial changes, the SOP requires that the original DAC should continue to be amortized by treating the new contract as a continuation of the original contract.

Recent Developments

At its July meeting, the AcSEC voted to make changes to the draft SOP based on comments received from the FASB. The FASB questioned how the guidance included in the draft SOP could indicate that (1) adding a guaranteed minimum return does not change the fundamental nature of contracts, while (2) capping the returns fundamentally changes the contract. The FASB suggests that these two situations are treated similarly: adding a guaranteed minimum return is treated as a fundamental change—the same as adding a cap on investment returns.

The FASB also questions the appropriateness of capitalizing sales inducements and acquisition costs associated with internal replacement contracts that are substantially unchanged, instead of expensing them as incurred. Additionally, the FASB does not agree that sales inducements offered in conjunction with an internal replacement that results in a substantially unchanged contract are accounted for, as if the sales inducement were explicitly identified in the original contract at inception—i.e., the FASB did not see these inducements as eligible for capitalization, as they did not exist in the original contract at inception.

The AcSEC reconsidered these items and voted to make changes to the SOP in accordance with the FASB's comments. The AcSEC also agreed to defer the proposed effective date of the SOP until 2006.

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