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Changes to DAC: Some Things You Want to Know About ASU 2010-26

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"Why now?" and "Why this amount?" These are the two questions most often asked by accountants when there is a change in GAAP balances. And these are two very important questions to answer about ASU 2010-26 *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts.* ASU 2010-26 is the new Financial Accounting Standards Board (FASB) guidance which changes the definition of costs related to the acquisition of new and renewal insurance contracts that can be capitalized. This new guidance will have significant impacts on GAAP financial statements for financial periods beginning after Dec. 15, 2011.

WHY NOW?

Some stakeholders had become concerned about the diversity of practice in the costs that were being capitalized and amortized as deferrable acquisition costs (DAC). Specifically, concerns about the treatment of advertising costs triggered the FASB review of industry practice. However, FASB's review was expanded to include all aspects of deferrable expenses, and ultimately resulted in a change in the definition of deferrable acquisition costs in order to create a more consistent financial reporting standard for life insurance contracts. Some have argued for a delay in the timing of this change until a unified standard could be worked out under convergence with IFRS, but key stakeholders wanted to complete this work on a more rapid timetable.

WHY THIS AMOUNT?

Under current GAAP, deferrable acquisition costs are those that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Generally these costs are determined for a block or portfolio of business, not strictly limited to costs incurred on individual contracts actually sold. The requirement that costs vary with the acquisition of contracts is also not currently limited to strictly incremental acquisition costs. ASU 2010-26 tightens the DAC definition to "costs that are related directly to the successful acquisition of new or renewal insurance contracts," based on the following criteria:

- Incremental direct costs that are essential to contract acquisition.
- Certain costs related directly to the following acquisition activities performed by the insurer for the contract:
  - Underwriting,
  - Policy issuance and processing,
  - Medical and inspection, and
  - Sales force contract selling.

The revision in the definition of deferrable expenses is expected to result in a decrease in amounts deferred, and therefore a reduction in GAAP DAC balances, for many companies.

GOOD NEWS FOR ACTUARIES

Certainly the new definition of DAC results in a lot of work for companies. Expense research, time studies, allocation formulas, etc. must be reviewed. DAC amortization schedules are affected. If a company chooses to apply the definitions retrospectively to prior DAC schedules, it could result in quite an effort. But for financial reporting actuaries there is some good news. Most of the expense effort falls on the accounting community! Of course financial reporting actuaries will be involved, but they don't carry the entire burden of the work. All kidding aside, the third and fourth important questions to answer are: "How does this affect my company?" and "What are a few specific issues to watch for?"

HOW DOES ASU 2010-26 AFFECT MY COMPANY?

First, as was stated, ASU 2010-26 changes the requirements for deferability of acquisition expenses. The company must at least review its current expense structure and apply the new guidance when determining new DAC amounts for financial reporting periods after Dec. 15, 2011. The company may also want to apply the standard to prior years. If retrospective application is elected, historical expense data must be obtained and analyzed, and initial DAC amounts restated for as many past years as possible. Trending of data backwards after a number of years may be acceptable if the results of the data collected support applying the assumption to prior periods.

If retrospective application is elected, DAC balances will need to be restated for each DAC amortization

cohort schedule. In many cases simple ratio techniques may be adequate to complete the task, but there are instances where the financial reporting actuary may wish to rerun the system with new DAC amounts from issue for each cohort.

Finally, depending on the amount of historical data a company publishes, the company will generally need to restate prior quarterly and annual results using the retrospective application of ASU 2010-26.

WHAT ARE SOME SPECIFIC ISSUES TO BE AWARE OF?

Term

For FAS 60 Term and Non-Participating Life products, in the event of retrospective adoption, the amounts previously capitalized (DAC) should be adjusted to reflect the new guidance. However, the assumptions used in the calculation of liabilities (including maintenance expenses) should not change. Unless there is a "loss recognition event," the amounts capitalized are amortized in proportion to gross premiums, where the rate of amortization is calculated using assumptions locked-in at issue. For most cases, then, the rate of amortization of adjusted DAC should not change. Therefore, new DAC balances can normally be calculated by applying the ratio of new/previous deferred expenses to the previous DAC balance (i.e., pro rata).

For FAS 97 Limited Pay contracts (which are in many respects similar to FAS 60 products), the amount of Deferred Profit Liability (DPL) depends on the capitalized amount; therefore the DPL will increase. However, as is the case for DAC, the rate of amortization should not change (unless there was a "loss recognition event"), so restated DPL balances could be calculated pro rata. In some cases, shadow loss recognition reserves may change also.

UL/Par Life

For Universal Life/Par Life contracts, insurers amortize acquisition costs in proportion to estimated gross profits (EGPs) or estimated gross margins (EGMs) over the life of a book of contracts. Typically, similar contracts issued within the same calendar year are grouped together as a single cohort for purposes of DAC amortization. It is important to note that ASU 2010-26 does not change the definition of EGPs or EGMs. Previously capitalized costs, which are no longer deferrable under ASU 2010-26, should not be included in EGPs/EGMs as costs incurred for contract administration. Actual gross profits/gross margins from past periods used to amortize acquisition costs do not change either, while the amortization ratio does (as the past and future capitalized amounts change). This means that, similar to Term policies (FAS 60), the rate of amortization of capitalized amounts will not change. Generally, the new DAC balances could be calculated in proportion to changes in capitalized amounts unless there was a "loss recognition event" or unless there are significant renewal year DAC amounts in a cohort. Shadow DAC balances should also be recalculated.

The new guidance should not have an impact on Terminal Dividend Liability, Unearned Revenue Reserve, Sales Inducement Asset and SOP 03-1 liability calculations.

Retrospective Application

In deciding whether to elect retrospective application, a company should consider several issues. Since ASU 2010-26 will generally result in lower new deferral amounts, this will generally cause a decrease in GAAP operating earnings and net income for an ongoing operation. If a company does not adopt retrospective application, new DAC cohort schedules will be on a different basis than old schedules and a full transition

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to the new standard will not actually occur until all old business has rolled off of the DAC models. Adoption of retrospective application of ASU 2010-26 allows a company to put all business (new and existing) on the new basis immediately. Retrospective application will generally lower existing DAC balances, resulting in lower impacts to GAAP operating earnings and net income in future years.

Some of the issues companies considered in the past should be reconsidered. By way of example, years in which the company encountered a cap on DAC and calculation of any shadow loss recognition reserves will take special attention. The guidance probably does not impact the current net reserves for blocks of business in loss recognition, but any restatement of financial results prior to the loss recognition event may be impacted.

Of course, retrospective application will require more work. In addition, because of the decrease to DAC balances, GAAP capital will be reduced. Measures such as debt-to-capital ratios and book value amounts will be impacted. For companies with contractual arrangements tied to these ratios, this issue should be considered carefully.

CONCLUSION

The new DAC requirements in ASU 2010-26 will bring more work to both the accountants and the actuaries, particularly if the company elects to apply the standard retroactively. On the positive side, there should be greater consistency in expense practice in the industry. Also, since DAC balances will likely be lower, it could lower the volatility of a company's GAAP results. Finally, the additional insight to the company's deferrable expenses and conversion calculations will certainly help as we do this again in a few years when the new insurance contract accounting standard comes into effect!

The Life Financial Reporting Committee of the American Academy of Actuaries is working on a Public Policy Practice Note with further details on this issue. Be sure to look for that paper, which will soon be released. ■