



SOCIETY OF ACTUARIES

Article from:

The Financial Reporter

June 2012 – Issue 89

Implementation of ASU 2010-26

By Thomas W. Fineis, Jeffrey R. Lortie, and Kathryn M. Nelson



Thomas W. Fineis, FSA, MAAA, is a director, for Deloitte Consulting LLP in Chicago, Ill. He can be contacted at tfineis@deloitte.com.



Jeffrey R. Lortie, FSA, MAAA, is a manager for Deloitte Consulting LLP in Chicago, Ill. He can be contacted at jlortie@deloitte.com.



Kathryn M. Nelson, FSA, CERA is a consultant for Deloitte Consulting LLP in Minneapolis, Minn. She can be contacted at katnelson@deloitte.com.

This article provides a discussion of the manner in which actuaries have implemented the Financial Accounting Standards Board's (FASB) Accounting Standards Update (ASU) 2010-26, *Accounting for Costs Associated With Acquiring or Renewing Insurance Contracts*, for purposes of disclosure statements in conjunction with the Dec. 31, 2011 US GAAP financial statements, implementation for financial reporting on a post-ASU 2010-26 basis as a normal course of business starting in 2012, and an evaluation of the impact on unamortized deferred policy acquisition cost asset balances as of Dec. 31, 2011. Our focus is on the retrospective implementation of the ASU as that presents more considerations than the prospective application. This article does not, nor does it intend to, provide accounting guidance.

In October 2010, the FASB approved ASU 2010-26, which modifies the definition of deferrable expenses to include only direct, incremental costs related to successful contract acquisition efforts. This ASU is effective for fiscal years beginning on or after Dec. 15, 2011.

Before the issuance of the ASU, ASC 944-30-20 defined acquisition costs as follows:

“Costs incurred in the acquisition of new and renewal insurance contracts. Acquisition costs include those costs that vary with and are primarily related to the acquisition of insurance contracts.”

The revised guidance contained in the ASU establishes a higher threshold at which costs meet eligibility for deferral, and therefore will generally result in fewer cost deferrals than in the past as ASU 2010-26 allows for the capitalization of only those costs incurred in the successful acquisition of new and renewal insurance contracts. The items that are likely to be impacted include unamortized deferred policy acquisition cost balances (DAC), deferred tax assets or liabilities (DTA/Ls), shadow DAC balances, shadow DTA/Ls, and the deferred profit liabilities associated with limited pay contracts.

The ASU allows for prospective or retrospective application to prior periods. The expectation is that future deferrals will be less under ASU 2010-26 and, if the retrospective application is elected, that historical DAC balances will decrease with less amortization expense through income on the existing in force in the future.

PRACTICAL CONSIDERATIONS

Upon electing the retrospective application of ASU 2010-26, companies have had to consider several matters related to the implementation:

1. What historical point in time should be used as the starting point for retrospective application?

In order to apply the ASU retrospectively, historical information is required. The issue is how far back in time there is sufficient historical information available to adjust prior year deferrals and to determine a uniform timeframe for different products and lines of business. Technical Inquiry Service (TIS) Section 6300.38 published by the American Institute of Certified Public Accountants (AICPA) further addresses the accounting issues for selecting the historical starting point, to which we direct the interested reader.

2. Can a company use estimates in determining the restatement effects of the ASU?

The issue is to what extent a company can incorporate estimates to determine the impact of ASU 2010-26 for those years in which historical data is not available. Paragraph BC16 of the Background Information and Basis for Conclusions section of the ASU offers guidance as to reasonable estimates, to which we direct the interested reader. In our experience, most companies appear to have applied some degree of estimates based on adequate support to determine the effect of ASU 2010-26.

3. If retrospective adoption is elected, how do companies compute the impact on unamortized DAC balances?

Requirements of Retrospective Adoption

The retrospective adoption of ASU 2010-26 requires more than just quantifying the impact on the unamortized DAC balance as of Dec. 31, 2011. The impact on prior year-end financial statements, and other additional disclosures, may need to be provided. The required number of years for which the ASU impact should be disclosed is out of the scope of this article. In particular, it is required that companies:

- Reflect, “in the carrying amounts of assets and liabilities as of the beginning of the first period presented,” the cumulative effect of the change on periods before the periods presented.
- Make an offsetting adjustment, if any, “to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.”
- Adjust the “[f]inancial statements for each individual prior period presented ... to reflect the period-specific effects of applying the new accounting principle.”

Hindsight Is Not Always 20/20

Evaluating the disclosure impact on prior year-end financial statements raises some practical considerations. For example, in determining the impact on unamortized DAC balances as of a valuation date prior to the earliest period presented on the consolidated

financial statement, it is important to consider the analysis in absence of any hindsight that could be applied. In particular, restated DAC balances as of a prior reporting date ideally would be based on the “view of the world” at that prior date, including assumptions that were in effect as of those periods (i. e. , excluding any subsequent unlocking and/or true up for actual gross profits for ASC 944-20-05 (formerly FAS 97), or gross margins for ASC 944-20 (formerly FAS 120)).

Consider the following example of a single premium deferred annuity issued in 2008 with a five-year amortization period and a 5 percent discount rate. At issue, the unamortized DAC schedule is based on \$100 of acquisition expense and \$40 per year of estimated gross profits (EGPs), and is determined in column (8) of the table below.

In 2008, the actual gross profit (AGP) equaled the 2008 EGP. In 2009, the AGP deviated from expectation (\$20 versus \$40, see column (9)), though the deviation is expected to be temporary, and no adjustment is made to future gross profits. As such, the unamortized DAC is re-determined in column (10). In 2010, profits were again trueed up, and prospective assumptions are now less favorable such that EGPs were reduced in future years, as seen in column (11). The unamortized DAC is re-determined in column (12). In 2011, experience is consistent with expectation, and there is no change anticipated to the 2012 EGP.

(1) Calendar Year	(2) Deferral	(3) 2008 EGP	(4) DAC(t-1)	(5) DE	(6) Int	(7) Amort	(8) 2008 DAC(t)	(9) EGP(2009)	(10) DAC(2009)	(11) EGP(2010)	(12) DAC(2010)
2008	100	40.00	-	100.00	5.00	(23.10)	81.90	40.00	79.20	40.00	65.28
2009		40.00	81.90	-	4.10	(23.10)	62.90	20.00	70.26	20.00	48.68
2010		40.00	62.90	-	3.15	(23.10)	42.95	40.00	47.97	18.00	33.24
2011		40.00	42.95	-	2.15	(23.10)	22.00	40.00	24.57	18.00	17.02
2012		40.00	22.00	-	1.10	(23.10)	0.00	40.00	0.00	18.00	0.00

Shaded cells are actual reported balances

CONTINUED ON PAGE 24

... the method employed by the actuary to determine the impact of ASU 2010-26 is dependent upon the granularity of the ASU-updated deferrals ...

Question: If acquisition expense deferrals are reduced by 20 percent as a result of ASU 2010-26, what is the 2009 DAC balance to be disclosed?

Answer: Without proper care, the answer could be determined as 80 percent of \$48.68, or \$38.94, which may not be viewed as correct since the assumptions used to determine this amount are not consistent with the view of the world at the end of 2009, at which point future profits were assumed to be \$40 in all years. The intent of the historical disclosure is to report the financial results in such prior years had the ASU been in effect, and presumably not to benefit from perfect hindsight. The correct answer requires reference to the then-current unamortized DAC balance schedule: 80 percent of \$70.26, or \$56.21. If any financial statements were restated in past years due to errors, it would be appropriate to determine the ASU-adjusted DAC using the corrected amounts. Any new errors discovered as part of ASU implementation should be discussed with the company's external auditor for proper resolution.

Choice of Platform for Determining the Impact

In practice, the method employed by the actuary to determine the impact of ASU 2010-26 is dependent upon the granularity of the ASU-updated deferrals (in most cases, the actuary is a recipient of analysis performed by the company's accounting department to determine portions of prior deferrals considered direct and incremental), and the manner in which DAC is calculated (e. g., seriatim factors for FAS 60 vs. issue year cohort for FAS 97). In preparation for the estimated effects on adoption in 2012, companies took different approaches in performing the necessary quantifications in the 2011 financial statements, as described in the chart at the top of page 25.

a) Spreadsheet methods

We have observed several companies that employ a spreadsheet model for products that are subject to less complex guidance, such as FAS 60, and less complex deferral structures (e. g., all deferred expenses occur in year one of the contract). For example, we observed companies that split their FAS 60 factors between commission DAC and non-commission DAC to use a pro-rated non-commission DAC factor as the ASU only impacted non-commission DAC. The ratio of eligible deferrals to historic deferrals applied was either determined by year of issue, or on a more aggregated basis based upon a supportable explanation as to why the ratio did not vary significantly by issue year.

For certain products, a simple ratio approach might be appropriate, as long as the following conditions hold:

- i. No loss recognition events or other events have occurred in the past that resulted in adjustments to the unamortized DAC balance other than changes in assumptions or the passage of time.
- ii. The slope of deferrals is not materially affected.

Abiding by the concept that hindsight is excluded from the calculation, the ratio would be equal to $PV(\text{deferrals under ASU 2010-26})/PV(\text{original deferrals})$, applied to the unamortized balance.

Some conditions may require a more exact approach, in particular if the slope of the deferrals is altered. For example, suppose that the ASU-allowable deferrals are 50 percent of first year commissions and acquisition expenses, and 0 percent thereafter, as seen in column (3) of the table below. Without proper care, one might apply a ratio adjustment factor against the original DAC balances, such ratio computed as the present value of revised deferred expenses (column (3)) divided by the present value of original deferred expenses (column (1)). In this example, the ratio would be \$50 (revised deferred expenses) divided by \$152.67 (the present value of the original \$180 deferred expenses), or 32.75 percent.

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
Original Def. Exp.	Premium	Revised Def. Exp.	DAC(t-1)	Def Exp (t)	Amort (t)	Int(t)	DAC (t)	Orig. DAC (t)	Ratio x Original	Difference
100	100.00	50	0	50	13.79	2.35	38.56	61.75	20.27	-47.43%
20	84.90	-	38.56	-	11.71	1.75	28.60	45.83	15.05	-47.38%
20	76.30	-	28.60	-	10.52	1.17	19.25	30.88	10.14	-47.34%
20	72.37	-	19.25	-	9.98	0.60	9.87	15.84	5.20	-47.29%
20	71.52	-	9.87	-	9.87	0.00	0.00	0.00	0.00	-

Applying our previous example, we see the difference (column (11) chart above) that arises between the correct post-ASU DAC (column (8)) and what would be computed from applying a ratio adjustment factor against the original DAC balance (column (10)), per the table above.

For products subject to unlocking (e. g., deferred annuities under FAS 97), a plausible manner in which to determine the impact of ASU 2010-26 on prior DAC balances is to adjust the net amortization expense by the ratio of PV(deferrals under ASU 2010-26)/PV(original deferrals) if the slope of deferrals does not change materially over time as a result of DAC unlock-

ing or as a result of the ASU implementation. The net amortization expense for these purposes is defined as the sum of the amortization due to gross profits, any unlocking effect, and interest accrual. If the facts and circumstances are conducive to this technique, this approach expedites the historical restatement of DAC while adhering to prior periods' "view of the world" without having to resurrect old DAC models and assumptions. An illustration of the adjusted net amortization expense is illustrated in the table below and follows the scenario fact pattern of our single premium deferred annuity described above. Note that the only expenses capitalized occur in year one.

Calendar Year	(1) BOY DAC	(2) Deferral	(3) = (4) - (1) - (2) Net Amort	(4) Pre-ASU EOY DAC	Calendar Year	(5) BOY DAC	(6) Deferral	(7) = (3) * (6) / (2) Net Amort	(8) Post-ASU EOY DAC
2008	0.00	100.00	(18.10)	81.90	2008	0.00	50.00	(9.05)	40.95
2009	81.90	-	(11.64)	70.26	2009	41.00	-	(5.82)	35.13
2010	70.26	-	(37.02)	33.24	2010	35.10	-	(18.51)	16.62
2011	33.24	-	(16.21)	17.02	2011	16.60	-	(8.11)	8.51
2012	17.02	-	(17.02)	0.00	2012	8.50	-	(8.51)	0.00

CONTINUED ON PAGE 26

b) Full model recalculations

For various reasons, including complexity/granularity of deferral adjustments and the desire to avoid a temporary solution for the annual disclosure at year-end, only to revert to the current-state valuation model, many companies generated results using the same platform upon which the US GAAP valuation is performed. Additional benefits included a head start on the process used for ongoing financial reporting, as well as the removal of any potential noise with respect to timing differences (e. g., monthly in the valuation system, but quarterly or annual in the spreadsheet to save rows and/or columns).

Consideration of past loss recognition events

Certain scenarios may lead to past loss recognition events that create additional complexity in the application of ASU 2010-26. Of particular interest are those situations in which the relationship between the Gross Premium Valuation reserve (GPV) and the net GAAP liability (benefit reserve less DAC) changes when applying ASU 2010-26.

Calendar Year	Benefit Reserves	DAC	GPV	Loss Recognition Event?	DAC Post-Loss Recognition
2007	0	100			
2008	100	90			
2009	200	80	160	Y	40
2010	300	70			35
2011	400	60			30

Calendar Year	Benefit Reserves	DAC	GPV	Loss Recognition Event?	DAC Post-ASU
2007	0	25			
2008	100	22.5			
2009	200	20	160	N	20
2010	300	17.5			17.5
2011	400	15			15

Consider a 10-year term life product issued on Jan. 1, 2007 with the schedule of benefit reserves and DAC over a five-year period (through end of 2011) shown in the table below (top). In 2009, the company performed a loss recognition analysis, and the gross premium valuation was \$160, so the DAC was written down from \$80 to \$40.

Now, consider the ASU which dictates that 25 percent of the original deferral is allowed. In looking at 2009, when the loss recognition occurred prior to implementing ASU 2010-26, we see that there would not have been a loss recognition event had ASU 2010-26 been in place. As such, the 2009 and later financial statements would be restated, and it would be necessary to use 25 percent of the original schedule, not 25 percent of the schedule that included the reduction due to loss recognition. (See bottom table below)

WHAT HAS BEEN THE IMPACT FROM ADOPTION?

After having offered commentary on the various methods and considerations companies used to quantify the impact of ASU 2010-26 per the above, it is worthwhile to comment on the observed practices and estimated financial impacts across companies. We selected 25 insurance companies based on the availability of SEC filed 10Ks at the time our research was conducted. These companies represent life and multi-line (life and property and casualty) insurers with a range of product types with assets ranging from \$4 billion to more than \$700 billion. We make the following high-level, broad-based observations from our inspection of companies' 2011 SEC 10K footnotes:

- Although early adoption of ASU2010-26 was permitted, we noted the majority of companies elected to adopt the provisions effective Jan. 1, 2012. We identified only one of the 25 companies surveyed that implemented during 2011. For the company that early adopted, no explanation for the early adoption was made in its 2011 disclosure.
- As noted above, the guidance allows for either retrospective or prospective adoption, but 21 of the

25 companies we surveyed adopted the guidance retrospectively. The companies using the retrospective method plan to apply the impact of ASU-2010 in an adjustment to the opening balance sheet of the earliest period presented in the 2012 financial statements. Once again, there was no reason provided in the 2011 disclosure for the selection basis.

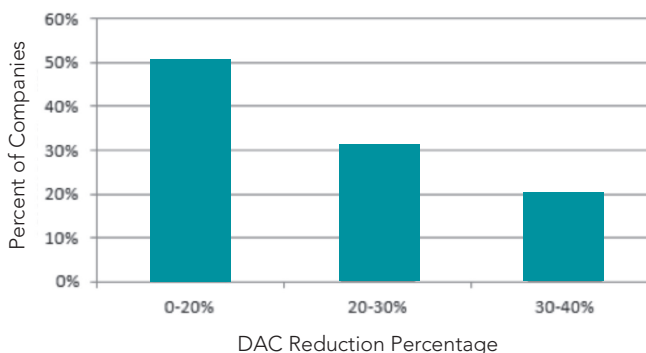
- In the footnotes, the level of detail provided on the financial impact that the retrospective adjustment would have on prior year-end financial statements ranged from a point estimate to a detailed breakdown by year. The majority of the companies we surveyed simply disclosed the estimated cumulative effect the retrospective adoption would have on financial statements as of Jan. 1, 2012. Of the 21 companies adopting the ASU retrospectively, 11 companies disclosed the impact the standard would have on the DAC balance. Of those companies, we observed a fairly wide range of impact on the DAC balance. Depending on the type of business sold, the reduction in DAC balances companies reported for their aggregated business ranged between 12 percent and 36 percent. We have summarized the distribution of DAC reduction in the histogram to the right.
- Each company's footnotes provided a varying level of detail and, as noted, not all companies provided a quantification of the ASU's impact on the DAC balance. Another commonly disclosed item, though, was the cumulative estimated impact the adoption would have on shareholders' equity. We found 13 of the 21 companies retrospectively adopting the standard disclosed the estimated reduction in shareholders' equity as of Jan. 1, 2012. [Note these 13 companies are not necessarily inclusive of the companies that disclosed the DAC reduction.] This metric also provides insight into the adoption's effect because the reduction in DAC asset impacts the financial statements with a corresponding decrease to equity. We observed a more narrow range of estimated equity reduction ranging from 1.8 percent to 17 percent, with the majority

of companies falling in the 2 percent to 8 percent reduction range. We have summarized the distribution of equity reduction in the histogram below.

CONCLUSION

We view the actuarial implementation of ASU 2010-26 as a significant effort for most companies. While there may be facts and circumstances for certain product lines that lend themselves to expedited methods for retrospective implementation, such as those described herein, it would be prudent to carefully assess the proposed approaches for validity and potential oversights. ■

Retrospective Adoption Estimate of DAC Reduction as Disclosed in the 2011 Financial Statement, as of 1/1/2012



Retrospective Adoption Estimate of Equity Reduction as Disclosed in the 2011 Financial Statement, as of 1/1/2012

