Statutory Accounting Principles (E) Working Group
Hearing Agenda
October 15, 2020
10:30 A.M. – 12:00 P.M. Central

ROLL CALL

Dale Bruggeman, Chair	Ohio	Judy Weaver	Michigan
Carrie Mears / Kevin Clark, Co-Vice Chairs	Iowa	Doug Bartlett	New Hampshire
Richard Ford	Alabama	Bob Kasinow	New York
Kim Hudson	California	Melissa Greiner	Pennsylvania
Kathy Belfi / William Arfanis	Connecticut	Jamie Walker	Texas
Dave Lonchar	Delaware	Doug Stolte / David Smith	Virginia
Eric Moser	Illinois	Amy Malm	Wisconsin
Caroline Fletcher / Stewart Guerin	Louisiana		

NAIC Support Staff: Julie Gann, Robin Marcotte, Jim Pinegar, Fatima Sediqzad, Jake Stultz

Note: Webex Meetings may be recorded for future use.

ACA Risk Corridors Update: As a result of the Supreme Court decision, CMS has exposed draft guidance regarding how issuers must treat new recoveries of the risk corridor payments related to the 2014-2016 program in their medical loss ratio (MLR) and rebate calculations. CMS welcomes comments on this proposed guidance which has a comment deadline of Oct. 21. The exposure draft can be found at:

https://www.cms.gov/files/document/MLR-Guidance-RC-Recoveries-and-MLR.pdf

Ref #	Title	Attachment #	Agreement with Exposed Document?	Comment Letter Page Number
2019-24 SSAP No. 71 (Robin)	**Levelized and Persistency Commission**	**A-Agenda Item**	**No**	**AICPA- 1 IP – 4**

Summary:
The Working Group has been discussing agenda item 2019-24: Levelized and Persistency Commission since August 2019. During the Summer 2020 National Meeting (July), the Working Group exposed nonsubstantive revisions to *SSAP No. 71—Policy Acquisition Costs and Commissions* (SSAP No. 71) to clarify levelized commission guidance and provide additional direction regarding commissions that are based on policy persistency. The revisions also clarify that the recognition of commission expense is based on experience-to-date. The revisions exposed in July 2020 were consistent with the 2019 Fall National Meeting exposure, with the inclusion of guidance to clarify that reporting entities that have not complied with the original intent shall reflect the change as a correction of an error in the year-end 2020 financial statements.

Some insurers have entered into third-party arrangements with the intent to defer the recognition of commission costs. This goes against long-standing statutory accounting guidance and results in those insurers presenting a better financial position than actual results based on existing in-force insurance policies.

The proposed revisions are intended to clarify the original guidance in SSAP No. 71 regarding levelized commissions. The statutory accounting guidance in SSAP No. 71 has been in place since 1998, which is even before codification. The guidance requires full liability recognition of commission funding agreements. The exposure

requires reporting entities that have not complied with the original intent of the statement to reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to *SSAP No. 3—Accounting Changes and Corrections of Errors* in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, are to be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No 3.

Interested Parties' Comments:
Interested parties would like to propose the following edits to SSAP No. 71, similar to those sent in January 2020.

SUMMARY CONCLUSION

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets. For example, when commissions are paid directly to an agent based upon renewal such as in traditional trail commission arrangements, commission expense would be recognized when the obligating event (i.e., the renewal) occurs and the related premium revenue is recognized.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Other than the commission arrangements discussed in Paragraph 2, commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued ratably over each annual period based on experience to date for which the persistency commission will be paid.~~the policy period that the commission relates~~. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, A funding agreement is an agreement whereby a third party provides a lump sum of money in return for a stream of payments over a predetermined time period. The payment stream is fixed without regard to the traditional elements of continued premium payments or policy persistency. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions ~~FN~~.

~~New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.~~

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. ~~The nonsubstantive revisions adopted __________ regarding levelized commission intend to clarify the original intent of this statement. Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.~~

We request that the above edits be incorporated into the proposed Ref #2019-24.

In addition, we believe that what have been deemed non-substantive clarifications to the original intent of SSAP No. 71 proposed by the SAPWG in Ref #2019-24 are in fact **substantive modifications** that materially change accounting practices that were established long before the 2001 codification, and that continue today in many different forms

Per the SAPWG process, substantive statutory accounting revisions introduce original or modified accounting principles. Substantive revisions can be reflected in an existing Statement of Statutory Accounting Principles (SSAP) or a new SSAP. Nonsubstantive statutory accounting revisions are characterized as language clarifications that do not modify the original intent of a SSAP. SSAPs are considered the highest authority (Level 1) in the statutory accounting hierarchy.

The proposed accounting treatment in Ref #2019-24 is significantly different than the current interpretation of the original SSAP and general statutory principles, specifically, full recognition of an expense at the time the policy is issued versus incremental recognition of commission costs over time as the policy persists and they become legal obligations. The current proposed language does not address the many varying product/distribution compensation arrangements in the industry and IP believe this will cause unintended consequences. The link between the traditional elements such as policy persistency and the accrual of commissions is a long-standing principle. Eliminating the link to the policy persistency is not a clarification, it is a substantive change that modifies the original intent of SSAP No. 71, thus requiring further evaluation.

Interested parties believe that the exposure as written will also unintentionally impact the accounting for certain types of traditional trail commission arrangements that are commonplace in the market for life and annuity products. Although funding agreements can also have elements that are based upon policy persistency, there exists in the industry a longstanding practice of compensating agents directly based upon policy persistency. In these scenarios, the reporting entity has an agreement in place with agents that requires commission payment if and only if a policy persists (for example, at each annual renewal). If a policyholder opts not to renew, the reporting entity has no obligation to pay further commissions to the agent.

As written, interested parties believe this exposure would require the reporting entity to accrue these trail commissions at policy inception, which would be counter to the principles contained in SSAP No. 5R - *Liabilities, Contingencies and Impairment of Assets*. These commissions are not liabilities until the policy persists, and, until that time, the transaction obligating the entity has not occurred. Language added to paragraph 2 is intended to distinguish the scope of the guidance in paragraphs 3-5 from these traditional trail commission arrangements.

Further, interested parties strongly disagree with the modifications to paragraph 7. Reporting entities have filed annual statements based on the current interpretation of SSAP No. 71 with unqualified opinions from their external

auditors. Regulatory examinations have also been completed by various states of domicile insurance departments without adjustment. IP believe that if the proposed revisions are adopted and result in an accounting change, these should be reflected as a change in accounting principle. Per SSAP No. 3, "A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes." Reporting entities that in good faith applied a particular method by following SSAP No. 71 and were not required to adjust statements as a result of audits or regulatory examinations, should not be considered to have made an **accounting error**. As such, interested parties disagree with the modifications in paragraph 7. As noted above, the proposed revisions to SSAP No. 71 substantially change the interpretation that has been followed for years, and therefore, the original text would apply for a reporting entity that must change its method of applying the revised SSAP No. 71.

In summary, we recommend that the NAIC consider the changes contained in the current Ref #2019-24 exposure be reclassified as **substantive, that an issue paper be drafted, and that this be re-exposed and processed accordingly.**

AICPA Comments:
The American Institute of Certified Public Accountants' NAIC Task Force (Task Force) appreciates the opportunity to discuss our comments on Form A: Issue 2019-24, Levelized and Persistency Commission.

Our comments are in response to the proposed transition language in paragraph 7 related to the nonsubstantive revisions regarding levelized commissions:

> Effective Date and Transition
>
> 7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The nonsubstantive revisions adopted ________ regarding levelized commission intend to clarify the original intent of this statement. Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.

We believe that the requirement to account for this clarification as a correction of an error pursuant to SSAP No. 3 in the year-end 2020 financial statements would be a departure from how the NAIC has traditionally adopted clarifications to statutory accounting as changes in accounting principle. (We are not aware of any other examples of revisions to SSAPs being considered an error correction since the adoption of the revised NAIC *Accounting Practices and Procedures Manual* in 2001.) We believe that resolving the diversity in practice that currently exists in the accounting for levelized commission programs as the correction of an error would be inconsistent with the NAIC's recent treatment of other nonsubstantive revisions that were adopted to promote the uniform application of statutory accounting guidance. For example, any change in income tax balances that resulted from the comprehensive revisions to the SSAP No. 101 Q&A that were adopted in 2019 to clarify the application of the deferred tax admissibility calculation for year-end 2019 reporting purposes were allowed to be reported as a change in accounting principle in accordance with SSAP No. 3. (Since changes in DTAs only affect surplus, the issue of the income statement needing to be adjusted due to the year-end adoption of new accounting guidance did not exist in this instance, as discussed further below.)

We recommend that the NAIC consider revising the transition language in Issue 2019-24 to allow companies to account for the change as a change in accounting principle, in accordance with SSAP No. 3. Paragraphs 3 through 5 of SSAP No. 3 discuss the characteristics and application of a change in accounting principle,

> A change in accounting principle results from the adoption of an accepted accounting principle, or method of applying the principle, which differs from the principles or methods previously used for reporting purposes. A change in the method of applying an accounting principle shall be considered a change in accounting principle.
>
> A characteristic of a change in accounting principle is that it concerns a choice from among two or more statutory accounting principles. However, a change in accounting principle is neither (a) the initial adoption of an accounting principle in recognition of events or transactions occurring for the first time or previously immaterial in their effect, nor (b) the adoption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring.
>
> The cumulative effect of changes in accounting principles shall be reported as adjustments to unassigned funds (surplus) in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date if the new accounting principle had been applied retroactively for all prior periods.

We believe the proposed change meets the definition of a change in accounting principle, as we believe the alternative interpretation of the levelized commission guidance in SSAP No. 71 has been accepted in practice. Specifically, we are aware from comments received from industry that some regulators (as part of periodic financial examinations) have not objected to the classification of levelized commission programs with commission payments linked to persistency as allowable in accordance with paragraph 5 of SSAP No. 71.

In addition, we believe that treating the proposed change as a correction of an error will potentially result in challenges for certain reporting entities. For example, reporting entities that have followed the alternative interpretation of the levelized commission guidance in SSAP No. 71 would have previously expensed a portion of this adjustment in their quarterly financial statements filed throughout 2020. If the guidance is adopted for year-end 2020, this expensed portion would need to be identified and reversed in order to properly report the adjustment to the opening (i.e., January 1, 2020) balance of surplus for year-end 2020 reporting purposes, which would increase the complexity of adopting the change. An option to avoid these complications would be to account for the change in accounting principle as of January 1, 2021, which is consistent with the guidance in SSAP No. 3 to adopt new accounting principles at the beginning of the year.

We also wanted to bring it to the Working Group's attention that requiring this clarification to be accounted for as a correction of an error could result in the independent auditor being required to express a qualified opinion on the prior year audited statutory basis financial statements in accordance with AICPA standards. This consideration exists in situations where the misstatements are material but not pervasive to the financial statements unless the prior year financial statements are restated, regardless of the statutory account treatment provided by SSAP No. 3 to recognize the correction of the error.

Summary of key points from commenters and NAIC staff recommendations:

1) The revisions should be reclassified as substantive and IPs recommend an issue paper.)
2) The revisions are too extensive regarding renewal commission and would require premature liability recognition at policy inception of traditional persistency commission. The comments assert this is contrary to longstanding practice.
3) They object to treating the revisions as a correction of an error and instead prefer a "change in accounting principle." (Both IPs and AICPA)

The July 2020 and December 2019 Working Group exposures were essentially the same with the addition of the correction of error guidance. In September 2020, the interested parties provided comments reflecting the similar

themes as prior comments, but also provided new tracked revisions. (The IPs characterize these as similar, but they are not identical to the prior changes.)

Detailed review of the Interested parties proposed revisions.

a. **Paragraph 2 & 3 -** Interested parties propose adding new language that directly paid trailing commission is recognized on renewal in the acquisition cost paragraph 2. The interested parties proposed paragraph 2 revisions, shown as shaded text below, are intended to distinguish the scope of the guidance in paragraphs 3-5 from these traditional trail commission arrangements. Interested parties noted a concern that the exposure would require the reporting entity to accrue these trail commissions at policy inception, which would be counter to the principles contained in SSAP No. 5R— *Liabilities, Contingencies and Impairment of Assets*.

> For example, when commissions are paid directly to an agent based upon renewal such as in traditional trail commission arrangements, commission expense would be recognized when the obligating event (i.e., the renewal) occurs and the related premium revenue is recognized.

NAIC Staff does not recommend the revisions for the following reasons:

While NAIC staff agree that the intent of the agenda item is not to require accrual of traditional persistency commission on day one. NAIC staff note that there is diversity in practice regarding the use of commission terms and we are hesitant to recommend using the term trailing because people have mislabeled some of the funding agreements as persistency or trailing commissions.

The term "directly paid" trailing commission does not clarify if it is a street level agent or a third-party funding agent involved in a levelized commission arrangement agent being paid.

b. **Paragraph 3** – Interested parties propose to revise the following exposed language:

> Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

Interested parties suggested revisions are shaded:

> Other than the commission arrangements discussed in Paragraph 2, commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued ratably over each annual period based on experience to date for which the persistency commission will be paid.~~the policy period that the commission relates.~~ In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

NAIC staff does not recommend the interested parties' proposed revisions as the use of the word "paid" introduces confusing elements. NAIC staff notes that the intent of the exposed guidance is not to require day 1 accrual of traditional persistency commission. We note that commission terminology varies among insurers and recommends remaining as principle based as possible regarding types of commission.

NAIC staff cautions that some of the entities employing funding agreements were characterizing the repayment as persistency commission, even though the commission payments to the writing agents were owed (and typically paid by the funding agent) with the initial sale of the policy.

NAIC staff recommends deleting the exposed guidance in paragraph 3 and expanding the proposed guidance in paragraphs 4 and 5 as the issue is identifying funding agreements which have been mischaracterized as commission (including in some cases, renewal and persistency commission).

c. **Paragraph 4** – Interested parties propose a new more restrictive definition of a funding agreement, noting that a funding agreement payment stream is a lump sum of money in return for a stream of payments over a predetermined time period and the payments are fixed without regard to the traditional elements of continued premium or policy persistency. interested parties' suggested revisions are as follows:

> A funding agreement is an agreement whereby a third party provides a lump sum of money in return for a stream of payments over a predetermined time period. The payment stream is fixed without regard to the traditional elements of continued premium payments or policy persistence.

NAIC Staff does not recommend the revisions for the following reasons:

- The existing guidance in SSAP No. 71 notes that accrual of the levelized commission arrangement is required even if repayment is not guaranteed.
- The existing guidance does not require a fixed repayment or fixed time period of repayment. It specifically requires accrual even if repayment is not guaranteed.

NAIC staff recommends adding "which attempts" in paragraph 4 as shown as shaded text below:

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism which attempts to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

d. **Paragraph 5 -** Interested parties propose to remove the footnote regarding the link to traditional elements with comments that eliminating the link to the policy persistency is not a clarification, but a substantive change. Interested parties note that the link between the traditional elements such as policy persistency and the accrual of commissions is a long-standing principle.

> Exposed New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.

NAIC staff notes that the funding agreement guidance is focused on noting that a levelized commission arrangement is an attempt to disconnect the relationship between traditional elements and indicates that a levelized commission arrangement should not be used to avoid recognizing the funding agreement (levelized commission) obligations.

NAIC staff proposes being more explicit regarding the implicit assumptions about levelized commission.

NAIC staff agree that there is a longstanding link to traditional elements with directly paid agents who write the policies and NAIC staff believes that most reporting entities are consistent on this point when there is not a funding agreement.

However, NAIC staff cautions that the footnote was an attempt to address a reporting entity mislabeling a funding agreement structure as a persistency commission.

NAIC staff recommends that the Working Group make the following revisions which are illustrated as shaded text below:

- **Delete the exposed new footnote and**
- **Expose additional guidance for paragraph 5 that is more descriptive of what the substance of a funding agreement.**

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the direct selling agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions ~~FN~~. Arrangements that use a third party to pay agents who write policies for the reporting entity and the insured can be an attempt to de-link the relationship between the insurer and those agents and defer or levelize the acquisition commissions. The insurance reporting entity is required to recognize the full amount of earned commission costs to the direct policy writing agents even if those costs are paid indirectly to the agents by a third party through the use of levelized commission, or similar arrangement, which is in substance a funding arrangement. Having a third party pay commission costs to the selling agent is strong evidence of a potential funding arrangement which shall be recognized as a liability because the substance of the arrangement indicates that repayment is reasonable and probable, even if a contingency has been incorporated into the funding arrangement, unless the underlying policy has been cancelled. A third-party structure cannot recharacterize (e.g. by referencing policy persistency) and delay recognition of liabilities for initial sales commission owed from the writing of policies regardless of how a third-party arrangement is structured with regards to the timing of payment from the insurer. The amount owed for full initial sales commission shall be recognized immediately as the writing of an insurance contract is the event that obligates the insurer, and such action shall occur consistently among insurers. As such, this recognition is required regardless if the insurer owes a selling agent directly or if a third-party has been contracted to provide payment to the selling agent.

~~New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.~~

e. **Paragraph 7- Change in accounting** - Both interested parties and the AICPA disagree with correction of an error treatment and prefer classification as a change in accounting. (It is noted that referring as a correction in error could result with issues in previously filed financial statements, prior exams, prior unqualified audit the accounting approach.

NAIC staff recommends modifying the exposed revisions to remove the language on correction of an error and specify the nonsubstantive revisions have an effective date of Jan. 1, 2021.

f. More granular guidance - Interested parties believe not being more granular on types of commission will cause unintended consequences, and the following themes from their letter are noted:

- Concerns that a reporting entity would be required to accrue trail commissions at policy inception.
- Significantly different than the current interpretation, full recognition of an expense at the time the policy is issued versus incremental recognition of commission costs over time as the policy persists and they become legal obligations.
- Although funding agreements can also have elements based upon policy persistency, there exists in the industry a longstanding practice of compensating agents directly based upon policy persistency. In these

scenarios, the reporting entity has an agreement in place with agents that requires commission payment if and only if a policy persists (for example, at each annual renewal). If a policyholder opts not to renew, the reporting entity has no obligation to pay further commissions to the agent.

Because companies employ a large variety of commission structures, NAIC staff recommends remaining high level and continuing to reference SSAP No. 5 regarding liability recognition. NAIC staff also recommends remaining as principles based as possible regarding the types of commission and their recognition. Therefore the proposed revisions have less guidance on types of commission and more guidance on funding agreements.

NAIC staff notes that the issue is clearly distinguishing between persistency commission and funding agreements masquerading as persistency commission.

g. Substantive change – Interested parties recommend that the revisions be reclassified from nonsubstantive to substantive. These comments requests revisions and an issue paper asserting it is a material change to established practices:

  - Materially change established accounting practices

  - Significantly different than the current interpretation, full recognition of an expense at the time the policy is issued versus incremental recognition of commission costs over time as the policy persists and they become legal obligations.

NAIC staff asserts that the goal of this agenda item is to be consistent with the principles of what is a funding agreement. NAIC staff still believe that the proposed revisions are nonsubstantive and focused on clarifying existing guidance.

NAIC staff believes that if the SAP guidance is modified in ways that permit a delay in recognition of acquisition costs, that more companies will be compelled to enter these contracts to prevent competitive disadvantages. Such deferral would fundamentally change the underlying principle of expensing acquisition costs as incurred. This principle is a primary difference from GAAP capitalization of acquisition costs. If this occurs, the Working Group may want to undertake a project to reconsider the recognition of DAC.

Summary of Recommended Action:
NAIC staff recommends that the Working Group exposed the shaded revisions shown on the following page under the heading "Shaded SSAP No. 71 Revisions for October 2020 Working Group Discussion" with a shortened comment deadline of Oct. 30 to allow for discussion on the Nov. 12 call of the Working Group.

The key points of the proposed revisions are as follows:
- **Improved description of the funding agreements.**
- **Deletes some of the previously proposed revisions regarding of other types of commission to address the comments received regarding unintended impacts on traditional renewal commission.**
- **Modify the exposed revisions to remove the language on correction of an error; and**
- **Proposes the nonsubstantive revisions have a Jan. 1, 2021 effective date.**

The following pages contain:
1) Shaded SSAP No. 71 Revisions for October 2020 Working Group Discussion

2) July 2020 Previously Exposed SSAP No. 71 Revisions

3) A brief overview of GAAP treatment, which notes third party paid acquisition costs are also accrued in GAAP deferred acquisition costs.

The comment letters are included in Attachment B (19 pages).

Shaded SSAP No. 71 Revisions for October 2020 Working Group Discussion

2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism which attempts to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the direct selling agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions FN. Arrangements that use a third party to pay agents who write policies for the reporting entity and the insured can be an attempt to de-link the relationship between the insurer and those agents and defer or levelize the acquisition commissions. The insurance reporting entity is required to recognize the full amount of earned commission costs to the direct policy writing agents even if those costs are paid indirectly to the agents by a third party through the use of levelized commission, or similar arrangement, which is in substance a funding arrangement. Having a third party pay commission costs to the selling agent is strong evidence of a potential funding arrangement which shall be recognized as a liability because the substance of the arrangement indicates that repayment is reasonable and probable, even if a contingency has been incorporated into the funding arrangement, unless the underlying policy has been cancelled. A third-party structure cannot recharacterize (e.g. by referencing policy persistency) and delay recognition of liabilities for initial sales commission owed from the writing of policies regardless of how a third-party arrangement is structured with regards to the timing of payment from the insurer. The amount owed for full initial sales commission shall be recognized immediately as the writing of an insurance contract is the event that obligates the insurer, and such action shall occur consistently among insurers. As such, this recognition is required regardless if the insurer owes a selling agent directly or if a third-party has been contracted to provide payment to the selling agent.

New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The nonsubstantive revisions adopted ________ regarding levelized commission ~~intend~~are to clarify the original intent of this statement and are effective January, 2021. ~~Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.~~

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2. Acquisition costs are those costs that are incurred in the acquisition of new and renewal insurance contracts and include those costs that vary with and are primarily related to the acquisition of insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Acquisition costs and commissions shall be expensed as incurred. Determination of when acquisition costs and commissions have been incurred shall be made in accordance with SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets.

3. Contingent commission liabilities shall be determined in accordance with the terms of each individual commission agreement. Commission liabilities determined on the basis of a formula that relates to loss experience shall be established for the earned portion. Assumptions used to calculate the contingent commission liability shall be consistent with the terms of the policy contract and with the assumptions made in recording other assets and liabilities necessary to reflect underwriting results of the reporting entity such as retrospective premium adjustments and loss reserves, including incurred but not reported. Commission contracts that include persistency (or other such components) shall not use these clauses to defer recognition of commission expense. If a commission is based on annual policy persistency (or other similar components), the commission shall be accrued based on experience to date for the policy period that the commission relates. In regard to persistency commission, it is inappropriate to wait until the amount is fully earned and/or unavoidable to accrue experience to date commission expenses. Actual policy cancellation would reverse the accrual of the related persistency commission.

4. Levelized commissions occur in situations where agents receive normal (non-level) commissions with payments made by a third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents by the third party would ultimately be repaid (with interest explicit or implied) to the third party by levelized payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the reporting entity. (Note: levelized repayments made by the reporting entity extend the repayment period but might not be a straight-line repayment.) These transactions are, in fact, funding agreements between a reporting entity and a third party, regardless of how the payment to the third party is characterized. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

5. The use of an arrangement such as a levelized commission arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency, but rather are linked to the repayment of an advance amount paid by a third party to the agents requires the establishment of a liability by the reporting entity for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions [FN].

New Footnote – The guidance in this paragraph notes that levelized commissions which use a third party to pay agents that are linked to traditional elements require establishment of a liability for the amounts that have been paid to the agents and any interest accumulated to date.

Effective Date and Transition

7. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The nonsubstantive revisions adopted ________ regarding levelized commission intend to clarify the original intent of this statement. Reporting entities that have not complied with the original intent of the statement shall reflect the change as a correction of an error (as a mistake in the application of an accounting principle) pursuant to SSAP No. 3 in the December 31, 2020 financial statements. In accordance with SSAP No. 3, correction of all accounting errors in previously issued financial statements, for which an amended financial statement was not filed, shall be reported as an adjustment to unassigned funds (surplus) in the period in which the error was detected. Disclosure shall also occur in accordance with SSAP No. 3.

Comparison to U.S. GAAP and SAP:

- It has been a long-standing practice for both U.S. GAAP and SAP to recognize acquisition costs as they are incurred.

- Under U.S. GAAP, acquisition costs from successful contracts are recognized as intangible assets (known as deferred acquisition costs - DAC) and amortized into expense overtime. This amortization occurs consistently over the expected term of the contract. If the contract is terminated early, the deferred acquisition cost is written off and immediately expensed. U.S. GAAP follows this process as it allows for a matching of revenues and expenses – which is a U.S. GAAP concept.

- The immediate expensing of acquisition costs has been a key difference between SAP / GAAP since inception of SAP. This treatment is intentional because these are not "assets" that can be used to pay policyholder claims. Rather, these are incurred costs that are just deferred for expense recognition under GAAP for timing purposes.

- In 2010, U.S. GAAP moved closer to SAP with requiring immediate expense recognition for some "acquisition costs" that companies had previously been recognizing as DAC assets. This was because of discrepancies in practice regarding which acquisition costs should be recognized as assets under U.S. GAAP and amortized overtime into expense. With this guidance, U.S. GAAP stipulated that only certain acquisition costs from successful contracts are permitted to be recognized as assets and amortized into expense. (Commission costs from successful contracts are permitted to be capitalized as assets and amortized under U.S. GAAP – so those are still different between GAAP/SAP, but we include this information to highlight that if it wasn't for the U.S. GAAP intent to match revenues and expenses, then immediate expense recognition would occur as these expenses have been incurred and often paid.)

- With the issuance of the 2010 guidance, the Financial Accounting Standards Board (FASB) discussed independent third parties. With this discussion, the FASB confirmed that direct costs of contract acquisition that are incurred in transactions with both independent third parties and employees are deferrable in their entirety if the capitalization criteria are met. As such, the FASB does not have different treatment based on the inclusion of third parties. ASU 2010-26. The BOC paragraphs BC8-BC11 address third-party involvement:

> BC11. On August 19, 2010, the staff posted the staff draft to the FASB website. The staff draft did not formally seek comments; however, it welcomed input from interested parties. As a result, 10 comment letters were received. A number of constituents raised concerns with the staff draft, including concerns that the proposed guidance would result in economically similar acquisition costs (for example, commissions) receiving different accounting treatment depending on whether the person performing the acquisition activity was an independent third party or an employee. Concerns also were raised about the operationality of the model and the costs associated with applying it because many insurance agents might not qualify as independent third parties as defined but also are not employees. Others were concerned that the proposal would significantly differ from the direction of the Board's joint insurance project. In light of those concerns, at the September 16, 2010 meeting, **the Task Force decided to reverse its previous tentative decision and reached a final consensus that incremental direct costs of contract acquisition that are incurred in transactions with both independent third parties and employees are deferrable in their entirety if the capitalization criteria are met.**

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