

Statutory Issue Paper No. 71

Policy Acquisition Costs and Commissions

STATUS

Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 71

Type of Issue:

Common Area

SUMMARY OF ISSUE

1. 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 new and renewal insurance contracts (e.g., agent and broker commissions, certain underwriting and policy issue costs, and medical and inspection fees). Current statutory guidance on the accounting for policy acquisition costs and commissions is contained in Chapters 8 and 18 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies and Chapters 8, 17, and 21 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies. Under this current guidance, policy acquisition costs and commissions are expensed as incurred.

2. GAAP guidance on the accounting for acquisition costs is primarily contained in *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises* (FAS 60) and *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* (FAS 97). Under GAAP accounting, policy acquisition costs and commissions are deferred and amortized to income.

3. The purpose of this issue paper is to establish statutory accounting principles for policy acquisition costs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).

SUMMARY CONCLUSION

4. 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 *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*.

5. 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.

6. 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. These transactions are, in fact, funding agreements between a reporting entity and a third party. 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.

7. The use of an 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 requires the establishment of a liability for the full amount of the unpaid principal and accrued interest which is payable to a third party related to levelized commissions.

DISCUSSION

8. This issue paper maintains the current statutory accounting for policy acquisition costs and commissions which differs from GAAP. GAAP accounting for policy acquisition costs and commissions is driven by the objective of matching revenues and expenses, therefore these costs are deferred and amortized to income as the related premium is recognized as revenue for FAS 60 products or in proportion to estimated gross profits for FAS 97 products. The primary objective of statutory accounting is to measure solvency. The guidance adopted in this paper is consistent with the Statement of Concepts which states:

Accounting treatments which tend to defer expense recognition do not generally represent acceptable SAP treatment.

9. The statutory accounting principles established in this issue paper are consistent with *Issue Paper No. 50—Definitions and Classifications of Insurance Contracts* which rejects FAS 60 and FAS 97.

Drafting Notes/Comments

None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

10. Chapter 17, Other Liabilities, of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance on levelized commissions:

Levelized Commission

The accounting treatment for certain transactions, characterized as levelized commissions, which results in enhancement of surplus, has been determined to be inappropriate for statutory reporting.

These transactions are, in fact, funding agreements between an insurer and a third party. Agents receive normal (non-level) commissions with payments made by the third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents 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 insurer. 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 premium payment or the maintenance of the agents license with the insurer is not maintained with respect to the payment stream.

The use of an 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 advanced amount requires the establishment of a liability in the full amount of the unpaid principal and accrued interest.

11. Chapter 18, Commissions, of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies contains the following guidance on commissions:

Financial statements should not reflect paid or incurred commissions on an earned premium basis, except for commissions based on loss experience. If commissions by contract are paid on an earned premium basis, but are not dependent on the loss experience of the insurance written, a reserve should be established for unpaid commissions. This reserve shall also be offset against "Agents' Balances or Uncollected Premiums".

Commissions payable on reinsurance assumed business should be included as an offset to "Agents' Balances or Uncollected Premiums". Commissions receivable on reinsurance ceded business should be included as an offset to "Ceded Reinsurance Balances Payable", which are included in "Agents' Balances or Uncollected Premiums".

Contingent Commission

Some insurance companies, to encourage quantity and quality of production, or to penetrate a line of business or geographical area, will enter into special commission arrangements with some of their agents. The incentive for the selection of good risks is that the agent is allowed to share in the profitability of the insurance he produces. The terms of the arrangement usually will be set forth in a "contingency commission agreement", which is either incorporated as part of the agency contract or as a separate contract. The agreement will provide for the dates upon which accountings are to be rendered to determine the contingent commissions, items to be included in the calculation, and a provision for the calculation, if any, in the event the contract is canceled.

The determination of the contingent commission liability is based upon the terms of the commission agreement. If the contract specifies that commissions will be determined on the basis of a formula that relates to loss experience, a commission liability must be established for the earned portion. The unpaid liability for commissions that are based upon loss experience should be included in a separate liability heading - "Contingent Commissions and Other Similar Charges".

Some agency contracts provide for vesting of the agents' commissions for renewals or policy adjustments. The contract also may specify that the company will pay the agent for the commutation of commissions payable on future premium collections. Such payments must be included as a commission expense. If the company has incurred a liability to commute an agent's commission at the balance sheet date, the liability should be included as an offset to "Agents' Balances or Uncollected Premiums".

12. Chapter 21 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance on commissions:

Commission Incurred

Except for commissions on deferred and uncollected life insurance premiums, commissions are generally recognized as incurred in the Summary of Operations when it is probable that they will become payable.

13. Chapter 19 of the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies and Chapter 20 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies simply address the classification of expenses; therefore, there is no explicit guidance for taxes, licenses and fees and general expenses.

14. Chapter 8 of the Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies contains the following guidance:

In no event should a specifically described nonadmitted asset be recorded as an admitted asset or be used to defer an expense that has been incurred and has no liquidating value, e.g., material used in previous advertising campaigns or supplies that are not resalable.

Generally Accepted Accounting Principles

15. Statement of Accounting Concepts No. 6 establishes the following definition of an asset:
 26. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred.
16. FAS 60 contains the following guidance on the accounting for acquisition costs:
 28. Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred shall be considered acquisition costs.
 29. Acquisition costs shall be capitalized and charged to expense in proportion to premium revenue recognized. To associate acquisition costs with related premium revenue, acquisition costs shall be allocated by groupings of insurance contracts consistent with the enterprise's manner of acquiring, servicing, and measuring the profitability of its insurance contracts. Unamortized acquisition costs shall be classified as an asset.
 30. If acquisition costs for short-duration contracts are determined based on a percentage relationship of costs incurred to premiums from contracts issued or renewed for a specified period, the percentage relationship and the period used, once determined, shall be applied to applicable unearned premiums throughout the period of the contracts.
 31. Actual acquisition costs for long-duration contracts shall be used in determining acquisition costs to be capitalized as long as gross premiums are sufficient to cover actual costs. However, estimated acquisition costs may be used if the difference is not significant. Capitalized acquisition costs shall be charged to expense using methods that include the same assumptions used in estimating the liability for future policy benefits.
17. The guidance in FAS 60 was modified by FAS 97 as follows:
 22. Capitalized acquisition costs shall be amortized over the life of a book of universal life-type contracts at a constant rate based on the present value of the estimated gross profit amounts expected to be realized over the life of the book of contracts. The present value of estimated gross profits shall be computed using the rate of interest that accrues to policyholder balances (sometimes referred to as the contract rate). If significant negative gross profits are expected in any period, the present value of estimated gross revenues, gross costs, or the balance of insurance in force shall be substituted as the base for computing amortization.
 23. Estimated gross profit, as the term is used in paragraph 22, shall include estimates of the following elements, each of which shall be determined based on the best estimate of that individual element over the life of the book of contracts without provision for adverse deviation:
 - a. Amounts expected to be assessed for mortality (sometimes referred to as the cost of insurance) less benefit claims in excess of related policyholder balances
 - b. Amounts expected to be assessed for contract administration less costs incurred for contract administration (including acquisition costs not included in capitalized acquisition costs as described in paragraph 24)

- c. Amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances
- d. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as surrender charges)
- e. Other expected assessments and credits, however characterized.

24. The amortization method based on the present value of estimated gross profits described in paragraphs 22 and 23 of this Statement differs from that provided in Statement 60, which is based on expected premium revenues. This Statement does not define the costs to be included in acquisition costs but does describe those that are not eligible to be capitalized under this Statement. Acquisition costs are addressed in paragraphs 28-31 of Statement 60. Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period shall be charged to expense in the period incurred.

25. In computing amortization, interest shall accrue to the unamortized balance of capitalized acquisition costs and unearned revenues at the rate used to discount expected gross profits. Estimates of expected gross profit used as a basis for amortization shall be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised. The interest rate used to compute the present value of revised estimates of expected gross profits shall be either the rate in effect at the inception of the book of contracts or the latest revised rate applied to the remaining benefit period. The approach selected to compute the present value of revised estimates shall be applied consistently in subsequent revisions to computations of expected gross profits.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 8 - Other Admitted Assets, Chapter 17 - Other Liabilities, Chapter 21 - Commissions
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 8 - Other Admitted Assets, Chapter 18 - Commissions
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*

Generally Accepted Accounting Principles

- *FASB Statement of Accounting Concepts No. 6, Elements of Financial Statements*
- *FASB Statement No. 60, Accounting and Reporting by Insurance Enterprises*
- *FASB Statement No. 97, Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*

State Regulations

- No additional guidance obtained from state statutes or regulations.

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