1999

Comment letters on Discussion Paper, Accounting By Life Insurance Enterprises For Deferred Acquisition Costs On Internal Replacements Other Than Those Covered By FASB Statement No. 97

American Institute of Certified Public Accountants. Insurance Companies Committee

Date: February 9, 2000

To: Pat Meyer, Center for Knowledge & Research Services

From: Andrea Smith, Accounting Standards ads

Subject: DAC Discussion Paper comment letters

Enclosed are eleven comment letters and a list of respondents received in response to the Insurance Companies Committee's Discussion Paper, *Accounting By Life Insurance Enterprises For Deferred Acquisition Costs On Internal Replacements Other Than Those Covered By FASB Statement No. 97.*

Please keep these letters on file in the Center for one year from the above date. If you have any questions, please contact Kim Hekker at 6160 or myself at 6166.

Thank you.

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Enclosures

List of Respondents to the Discussion Paper: *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97*

Letter Number	Respondents	Affiliation
1	USAA Life Insurance Company	Industry
2	Louisiana Society of CPAs	State Society
3	Nationwide Financial Services, Inc.	Industry
4	Minnesota Mutual	Industry
5	ReliaStar Financial Corp.	Industry
6	Arthur Andersen LLP	Big 5
7	American Council of Life Insurance	Professional Organization
8	Todd H. Hangen, CPA	Practitioner
9	PricewaterhouseCoopers LLP	Big 5
10	American Academy of Actuaries	Professional Organization
11	KPMG LLP	Big 5

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Received 8/30/99

USAA®

USAA LIFE INSURANCE COMPANY

August 18, 1999

Ms. Elaine M. Lehnert
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1211 Avenue of the Americas
New York, NY 10036-8775

RE: "Discussion Paper: Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered BY FASB Statement No. 97"

Dear Ms. Lehnert:

USAA appreciates the opportunity to participate in the discussion on the above-referenced topic. This topic is timely for us as we are currently involved in several inforce conversion initiatives and have had to address how to appropriately account for these conversions. Our comments are outlined below.

Issue 1: Is authoritative guidance needed on the accounting for DAC in situations characterized as internal replacements.

We are skeptical that such guidance would be useful. Our primary concern is that the guidance would restrict insurance enterprises in their ability to engage in relatively common and important activities by imposing exceptionally adverse reporting consequences on certain transactions. The ability of an insurance enterprise to reform contracts is one such activity. Promulgation of restrictive criteria under which DAC assets would not need to be written off will lead to insurance enterprises making less than sound economic decisions to protect DAC assets.

Issue 2: Which of the views presented in the Discussion Paper is most appropriate and might there be other views that should be considered.

We believe that View B has substantial merit. While we agree with View C that the replacement of contracts with substantially similar terms should not result in a write-off of existing DAC, we would go further and say that contracts should be *substantially dissimilar* before DAC should be written off. This is consistent with the conclusion of the ETIF that an exchange of debt instruments with substantially different terms is a debt extinguishment. From our perspective, we believe that there is a continuation of the basic contractual relationship, and that the real (although intangible) economic asset that DAC represents to the enterprise has not been diminished.

We would define *substantially dissimilar*, however, very broadly. For example, an annuity contract and a universal life contract are substantially dissimilar, while the presumption would be that two annuity contracts are not.

Issue 3: What criteria can be developed for determining whether a replacement is between contracts that are substantially similar.

We believe most internal replacements encountered in practice will not involve contracts that are substantially similar assuming a narrow definition of *substantially similar*. Guidance following this approach will have a harsh impact on insurance enterprises. Further, having to determine whether contracts are substantially similar means the focus will shift to satisfying technical requirements and possible gaming, rather that looking to see if fundamental economic relationships in a broad sense have been changed. We think the focus ought to be on the intangible DAC asset itself. We believe that if the real (although intangible) asset represented by DAC on the balance sheet has not been diminished, then it should not be written off.

This is consistent with the perspective that insurance enterprises often view DAC assets at the aggregate level as relating to a block of business, not necessarily to individual contracts. If a given block of business can continue to support that DAC under recoverability tests, and if those original deferred costs are directly linked to that block (which is still the case even where internal replacements are involved), then from an economic perspective, writing DAC off is not justified. An analogy may be drawn to the intangible asset "goodwill" on a company's balance sheet. Goodwill is not written off even if a company undergoes radical change so long as the company has not experienced a loss of value.

Another inconsistency is that by writing off DAC on an internal replacement, the inference is that little, if any, costs were incurred to acquire the replacement contract. This is not the case as most of those costs incurred in connection with the replacement contract were in reality incurred with the issuance of the first contract. This is particularly true for direct writers, where there are no commissions on either the original or replacement contracts.

The use of present values of cash flows to establish similarity between contracts as suggested by EITF for debt extinguishments runs into difficulty as applied to insurance products. When contracts include *embedded options,* basic present value techniques need to be expanded. Stochastic simulation and option pricing techniques may become necessary to fairly evaluate a contract. As an example, a replacement annuity contract providing for a reduction in a guaranteed crediting rate offset by an increase in current credited rates should have a different present value of future cash flows when compared to a previous contract without these changes under a given set of interest rates and other assumptions. However, the two contracts may actually have the same value to the enterprise. One reason for this is that the results of cash flow projections are influenced by the choice of assumptions (such as interest rate scenarios and policyholder behavior and their interrelationships) and that frequently the enterprise will evaluate cash flow projections over a range of possible assumptions. If the two contracts are tested under a range of economic scenarios weighted by the likelihood of occurrence, it may be that overall they would be considered economically *similar*. Using one set of prescribed assumptions may not reflect this.

Issue 4: What costs (if any) should be considered as eligible costs for deferral in a replacement transaction.

Given a situation where the replacement contract is *substantially dissimilar* to the original contract such that writing off the DAC is justified, we believe the criteria for identifying deferrable costs on the replacement contract are the same as for any new contract, and that FASB Nos. 60 and 97 provide sufficient guidance. For replacement transactions where DAC is not required to be written off, additional DAC should be permitted if it meets the FASB Nos. 60 tests and if recoverability tests are satisfied.

We appreciate having the opportunity to comment on these issues.

Respectfully,

Ken Vande Vrede

Ken Vande Vrede, FSA

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September 22, 1999

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VIA FAX

Re: Discussion Paper-Accounting by Life Insurance Enterprises For Deferred Acquisition Costs on Internal Replacements other than those covered by FASB Statement No. 97.

Date: June 25, 1999

Response Prepared by: Accounting and Auditing Standards Committee
Society of Louisiana CPA's
Vance R. Balles, CPA, CVA
John Cameron, CPA
Bruce Wampler, CPA

The above committee members all agreed that View A was the most desirable alternative. It appears to be the most conservative approach.

The essential difference between views A and B relates to whether Deferred Acquisition Cost should follow the contract or the customer. It seems to us that the costs are associated with the contract, a viewpoint that is supported by the fact that selling costs are not capitalized unless a contract results (an analogy is successful-efforts accounting for the oil and gas industry). If the contract no longer exists, then there can be no basis for continuing to carry an asset related to the contract.

In reading View C the EITF acknowledged that an exchange on modification in terms that are substantially similar did not result in an extinguishment. Considering this, treating an internal replacement similar to an extinguishment of debt would trigger the write off of any unamortized deferred acquistion costs related to the initial contract.

A fourth alternative (not mentioned in the Discussion Paper) would be to continue to amorize the DAC related to the original contract, but immediately expense all acquisition costs related to the replacement contract. Under this approach, the costs associated with the replacement contract are viewed as unnecessary, in the sense that they could have been avoided had the insurance company originally sold the policyholder the "best" product. Since these cost are unnecessary, they should not be viewed as an asset and should not be capitalized.

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Elaine M. Lehnert, Technical Manager
AICPA
September 22, 1999
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One of the key issues appears to be the criteria for determining whether an internal replacement should be considered a new contact or a continuation of the original contract. Also, criteria for determining if a contract is substantially similar or different should be addressed. Until these criteria can be established and agreed upon, the accounting treatment of internal replacements within the Life Insurance Industry will probably remain inconsistent. It is important to have consistency within the industry as the public evaluates/chooses which company to do business with.

Respectfully,

John Cameron

JOHN CAMERON, CPA
SOCIETY OF LOUISIANA CPA's
COMMITTEE MEMBER

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Nationwide is on your side

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September 24, 1999

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Re: Invitation to Comment, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97*

Dear Ms. Lehnert

Nationwide Financial Services, Inc. (NFS) appreciates the opportunity to provide its comments on the AICPA Discussion Paper, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97.* NFS is the holding company for Nationwide Life Insurance Company, the third largest writer of individual variable annuity contracts in the United States during the year ended December 31, 1998.

Regarding Issue 1 of the Discussion Paper, which requests comments on whether authoritative guidance is needed on the accounting by life insurance enterprises for deferred acquisition costs (DAC) on internal replacements other than those covered by FASB Statement No. 97, NFS is not aware of any substantial diversity in practice related to this issue that would warrant the development of additional authoritative guidance. While some diversity surely exists, we do not believe that the comparability of financial statements among life insurance enterprises has been materially affected. In addition, we don't believe internal replacement activity has been significant for most insurers.

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Although we believe no additional authoritative guidance is needed at this time, we would like to take the opportunity to provide some comments on View C as described in the Discussion Paper. View C would apply the debt extinguishment provisions of FASB Statement No. 125 and the guidance for debt exchanges and modifications established by EITF No. 96-19 to life insurance product internal replacements. We believe the similarity test provisions of this view have some merit; however, if it is decided that guidance should be developed for internal replacement transactions, we would like to see the provisions of this view described and reviewed in more detail before a final method is selected. Specifically, we would recommend further details be provided as to how the 10 percent test to determine if insurance contracts are substantially different would be applied in practice. For instance, it would be helpful to know exactly what cash flows would apply to the test, e.g. only cash flows between the insurance provider and the customer or also include cash flows with third parties, such as distributors and mutual fund houses. Also, due to the significant nature of some third party payments in many internal replacement transactions we believe that capitalization of those payments in addition to the unamortized DAC on the original contract would be appropriate if the contacts are not determined to be substantially different. This is inconsistent with EITF No. 96-19 which requires that all costs incurred with third parties be expensed as incurred if a replacement debt instrument is not substantially different from the original.

Again, NFS appreciates the opportunity to comment on this issue and looks forward to reviewing the results of the comment period. We would be pleased to discuss our comments with the AICPA or its staff at their convenience.

Sincerely,

David A. Jacoby

David A. Jacoby
Associate Vice President – Controller
Nationwide Financial

September 24, 1999

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Elaine M. Lehnert, Technical Manager
Accounting Standards, File 3162
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1211 Avenue of the Americas
New York, NY 10036-8775

RE: Comments on Discussion Paper, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97*

Dear Ms. Lehnert:

Minnesota Life appreciates the opportunity to comment on the above discussion paper prepared by the Insurance Companies Committee of the AICPA. We offer the following comments to the first three issues presented in the discussion paper.

1. Whether authoritative guidance is needed on the accounting by life insurance enterprises for deferred acquisitions costs (DAC) in situations characterized as internal replacements.

We believe authoritative guidance is needed, and support the Committee's efforts to bring uniformity to the reporting of internal replacements.

2. Which of the views presented herein is most appropriate and whether there are other views that should be considered.

We support View C, which recognizes that the replacement of one insurance/investment contract with another contract with substantially similar terms should not result in a write-off of any unamortized DAC related to the initial contract.

We recognize the Board's position in FASB Statement No. 97 concerning replacements of traditional life contracts by universal life-type contracts. We also recognize the Board did not accept the argument that the replacement contract represented a continuing relationship between the insurer and the policyholder, and therefore, the new contract represented only a change in the form of insurance protection.

However, Minnesota Life has a long-standing position of offering policy exchanges on a favorable basis to ensure existing policyholders are treated equitably in comparison to new policyholders. Therefore, we attempt to make new products available to existing policyholders, on an internal replacement basis, at a minimal cost with no commissions paid on the transaction. As a consequence, we have a high percentage of our policyholders that choose to switch to new products when they are introduced. In most

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cases, the internal replacement does not change the nature of the agreement between the policyholder and Minnesota Life.
Further, we consider internal replacements among Minnesota Life's Adjustable products to be unique from the industry treatment of internal replacements among universal life products. When a contract is exchanged for another contract, Minnesota Life has consistently treated the policyholder as if they were continuing the same contract. No additional compensation is paid on the new contract. From an administrative standpoint, the contract's original issue date is preserved; no changes are made to the duration considerations in the contract (i.e., the contract remains at the same point in scale). The select period for mortality charges is not reset, the contract year for compensation purposes is not reset, and the lapse duration for projections is not reset. For all practical purposes, Minnesota Life expects the new contract to act as if it were issued at the same time as the old contract. Thus, we not only treat the old and new contracts as substantially similar, we treat the new contract as if it were a continuation of the exact same contract.

We support the proposal to treat policies differently depending on whether or not they are substantially similar to new products.

3. What criteria can be developed for determining whether a replacement is between contracts that are substantially similar.

We support the development of objective criteria as a means to promote consistency in the reporting of these transactions in practice. We request the Committee to explore the following criteria:

- no or reduced underwriting effort related to the new contract unless the face amount on the new contract is higher than the face amount of the original contract.

- no additional commission paid on the continuing premiums above the old point in scale.

- future assumptions in the projection of gross profits similar to the old contract.

- no significant expected changes in persistency and other experience.

- no additional charges on the replacement transaction.

Again, thank you for the opportunity to comment. If you have any questions or would like to discuss our comments further, please don't hesitate to contact me at 651-665-4122 or david.leplavy@minnesotamutual.com.

Sincerely,

David J. LePlavy
Assistant Controller

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Senior Vice President,
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RELIASTAR

ReliaStar Financial Corp.
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September 25, 1999

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Re: Invitation to Comment, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97*

Dear Ms. Lehnert:

ReliaStar Financial Corp. appreciates the opportunity to comment about accounting for internal replacements. Following is our response to the six issues presented in your Discussion Paper.

Issue 1: Is authoritative guidance needed on the accounting by life insurance enterprises for deferred acquisition costs (DAC) in situations characterized as internal replacements?

We believe guidance is needed to promote consistency of practice. Current guidance allows but does not require carry-over amounts in certain internal replacement situations, which may create diversity in practice. Current guidance is also not specific as to the circumstances that would allow carry-over of amounts. Paragraph 26 of SFAS 97 explicitly prohibits the carry-over of amounts associated with an internal replacement of a traditional life insurance contract with a universal life-type contract. Paragraph .19 of Practice Bulletin 8 emphasizes that SFAS 97 addresses only replacement of traditional insurance contracts by universal life-type contracts. It also provides no elaboration on the rationale in SFAS 97 but indicates that "the accounting for other internal replacements should be based on the circumstances of the transaction".

Issue 2: Which of the views presented herein is most appropriate? Are there other views that should be considered?

We support the conclusion that continued deferral of DAC may be sometimes appropriate, which is allowed under varying circumstances under Views B of the Discussion Paper. We believe that the prohibition of deferral in View A is not consistent with existing accounting guidance and is not appropriate.

Both View B and View C of the Discussion Paper conclude that continued deferral of DAC may be sometimes appropriate. The difference between the two views hinges on the criteria for eligibility of deferral treatment.

We support View B. View B is consistent with the position that the internal replacement transaction represents a continuation of a contractual relationship between the insurer and the insured. We believe the carry-over of amounts under View B is appropriate because:

- An internal replacement program is generally designed to preserve or improve the ongoing economics of the customer relationship.

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- The ability to carry-over amounts in a replacement situation creates an accounting model consistent with the economic motives of the replacement. A reported GAAP loss in the period that the relationship with the customer has been changed or extended is inconsistent with the economic result of the transaction.
- The flexibility of today's insurance contracts already allows modification of the company-customer relationship. A replacement may be a more visible modification, but in substance can often be similar to flexible transactions allowed within a contract.

View C looks to the terms of the initial and replacement contracts as the chief criteria for eligibility for deferral of DAC. Debt instruments, which serve as the replacement model for View C, have markedly different underlying obligations and risks compared to those in insurance contracts. Consequently, we believe the guidance relating to debt instruments would be inappropriate to insurance replacement transactions.

View A of the Discussion Paper appears to be internally inconsistent. Paragraph 8 indicates that the write-off of costs should be extended by analogy to all types of replacements, which we interpret as no opportunity to carry-over amounts in any situation. Paragraph 10, however, suggests that the FASB's restriction in Statement 97 was appropriate to the products then under discussion, and may not be reflective of the FASB's views on other kinds of replacements. We interpret this statement to suggest there may be situations where carry-over is appropriate.

Issue 3: What criteria can be developed for determining whether a replacement is between contracts that are substantially similar?

- As stated above in Issue 2, we do not agree with View C.

Issue 4: What costs (if any) should be considered as eligible costs for deferral in a replacement transaction?

Eligible costs may include:

- Costs which meet the criteria for deferral under current accounting guidance.
- The unamortized portion of deferred acquisition costs of the replaced contract.
- The difference between the replaced contract's GAAP benefit reserve and the cash value transferred (which may include waiver of a surrender charge).

The sum of the second and third amounts may result in deferral of a gain or loss, depending on the relationship of the net GAAP reserve of the replaced contract to the transferred cash value.

Any amounts deferred should be subject to the usual test of recoverability. More stringent tests might be recommended such as:

- The total amounts deferred could be limited to an amount that would otherwise be deferred on a similarly issued new contract.
- Alternatively, a limit to total amounts deferred could be made such that the newly replaced contract has a profitability profile no less than that of a similar, newly issued contract. In other words, total amounts deferred may be further limited due to other factors, such as the impact on mortality margin

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in a replacement situation where no underwriting is done.

Issue 5: What other issues or practical considerations should be examined related to this topic?

Guidance is needed to more clearly define the conditions that create a replacement contract. Some criteria might include:

- The presence of an "inter-contract" transaction, that is, one contract funds the issuance of another contract.
- The level of commissions or other acquisition costs incurred on the replacement contract relative to a similarly issued new contract – reduced levels of acquisition costs may suggest a replacement contract.
- The existence of marketing programs such as an offer limited to existing policyholders only.
- Underwriting concessions or simplifications in the replacement contract.
- Forces that generated the replacement. Should there be accounting differentiation between a contract that was replaced due to internal forces (such as an internal replacement program sponsored by the insurance company) and one that was replaced due to external forces (such as an agent rewriting an existing contract to a different product with full agent compensation and full policyholder underwriting requirements)?

Accounting for carry-over amounts may create practical valuation issues. For example:

- DAC is often valued on a block of business, rather than seriatim by contract. Some guidance may be needed as to how to allocate unamortized DAC among contracts for the purposes of determining carry-over amounts.
- The ability to track replacement contracts may be difficult, unless they are a result of a "replacement program" developed by an insurance company.
- Guidance will be necessary on the treatment of historical profit margins in the amortization of products that are subject to ongoing unlocking due to experience (SFAS 97 investment and universal life contracts, and SOP 95-1 participating contracts). Should the change in profit expectations be reflected in a prospective fashion only? Practically, few companies capture estimated profit margins at the policy level. Valuation alternatives may include an amortization approach that commingles the actual profit margins of the replaced product with the expected profit margins of the replacement product.

Issue 6: The Insurance Companies Committee would like to further investigate the analogy between internal replacements and modification or exchanges of debt instruments....

Please see the related discussion under Issue 3 and Issue 4.

Thank-you for the opportunity to comment.

Sincerely,

James R. Miller, FSA, MAAA

Arthur Andersen LLP

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September 24, 1999

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Dear Ms. Lehnert:

We are pleased to have the opportunity to respond to the Discussion Paper, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97* (the "Paper"). Our summary comments are followed by responses to the specific issues posed by the AICPA's Insurance Companies Committee (the "ICC").

Summary Comments

We believe that authoritative guidance is needed and recommend that the ICC assign a project team to draft a prospectus to develop a Statement of Position or Practice Bulletin. We agree with the concept presented in View C; however, we are concerned with a methodology based on the present value of future cash flows. The use of future cash flows for debt may be appropriate, but it is not necessarily appropriate for insurance products. We suggest that the determination of "substantially different" be based first, on the product or class of product, and second, on the present value of estimated gross profits, a concept and model already in practice.

Comments on Specific Issues

Issue 1. Whether authoritative guidance is needed on the accounting by life insurance enterprises for deferred acquisition costs (DAC) in situations characterized as internal replacements.

Authoritative guidance is needed. Since the issuance of Statement on Financial Accounting Standards ("SFAS") No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments* ("SFAS 97") in 1987, there has been a substantial increase in the issuance of non-traditional insurance and investment-type products. Competitive pressures and the rapid development of new products and new product features have resulted in insurance enterprises seeking to convert existing policies to updated policies to counter a loss of business or to retain an existing policy base. For example, many life insurance enterprises sell investment products with a surrender charge. The surrender charge is a mechanism by which the insurance company can recover sales and installation costs in the event a policyholder surrenders his/her contract during the early years of its existence (historically seven years, with the charge decreasing over that period). As policyholders near the end of or eclipse the surrender period, sellers of investment products may attempt to convert a policyholder to a similar, but updated product with new features, at a different company. Existing literature, namely SFAS 97, and Practice Bulletin 8, *Application of 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* ("PB 8"), address only internal replacements of a traditional life insurance contract by a universal life insurance contract. Paragraph 26 of SFAS 97 is silent with respect to internal replacements other than universal life for traditional life. Paragraph 19 of PB 8 provides only little additional guidance, as it states, "the accounting for other internal replacements (other than universal for traditional) should be based on the circumstances of the transaction." Furthermore, in the basis for conclusion section of SFAS 97 (paragraph 72), the Financial Accounting Standards Board (the "Board") clearly analogizes internal replacements to an "extinguishment of debt" accounting model that has since been modified by Emerging Issues Task Force ("EITF") Issue 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments* ("EITF 96-19"). Due to the limited guidance in the existing literature and the proliferation of insurance/investment contracts, insurance enterprises are left to devise their own accounting policies, which results in diversity in practice.

Issue 2. Which of the views presented herein is most appropriate and whether there are other views that should be considered.

We believe that View C is the most appropriate. As mentioned in response to Issue 1, paragraph 72 of SFAS 97 states, "The Board recognizes that an insurance enterprise that conducts an internal replacement program may be motivated by a desire to retain its customer base and that the alternative to replacement may be the loss of that base. The objective is not, however, different from the objectives of similar transactions undertaken by insurance enterprises and other enterprises for which continued deferral of costs is not permitted, including the refunding of debt." Paragraph 72 refers to Accounting Principles Board Opinion No. 26, *Early Extinguishment of Debt*, as amended by FASB Statement No. 76, *Extinguishment of Debt* ("SFAS 76"), as the governing literature, which requires the write-off of unamortized costs associated with extinguished debt when the extinguished debt is relieved by a new liability to the same party. EITF 96-19 interprets the guidance presented in SFAS 76 to reflect that certain debt exchanges do not contain substantive modifications to the existing debt, resulting in unamortized amounts related to the old debt, and new fees exchanged between the parties related to the new debt, being amortized over the life of the new debt. However, costs paid to third-parties, as part of the replacement, would still be expensed as incurred. Therefore, the conclusions drawn by the Board as it relates to internal replacements could be interpreted similarly. As such, the concepts presented in View C, which analogize to the guidance contained in EITF 96-19, are the most appropriate.

View A is inappropriate because it is not supported by an existing accounting model (EITF 96-19 replaced the model upon which View A is built). View B also is inappropriate because, as part of the deliberations leading to Statement 97, the Board rejected an AICPA Issues Paper that suggested the "continuing relationship" concept.

Paragraphs 12 and 13 of SFAS No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases (An Amendment of FASB Statements No. 13, 60, and 65 and a Rescission of FASB Statement No. 17)* ("SFAS 91"), suggest an alternative accounting model related to internal replacements which might be considered. In summary, those paragraphs state that, 6 cont'd

from the lender's perspective, when a loan is refinanced with terms at least as favorable to the lender as terms for comparable loans currently offered to other customers with similar collection risks who are not refinancing, the loan shall be accounted for as a new loan, requiring the recognition in the income statement of any unamortized fees or costs. "Comparable terms" is defined as at least an equal effective yield of the new loan to currently offered loans. If that condition is not met, the unamortized fees and any penalties are carried forward. This model suggests, similar to View C, that circumstances might exist where unamortized balances are not taken into earnings.

EITF Issue 98-14, *Debtor's Accounting for Changes in Line-of-Credit or Revolving-Debt Arrangement* (EITF 98-14), further supports the concepts presented in View C. EITF 98-14 developed a model for determining whether modifications to line of credit or revolving debt agreements resulted in a new debt agreement. The model presented by EITF 98-14 is defined as the "borrowing capacity" of the agreement. "Borrowing capacity" is defined as the product of the term or remaining term of the agreement and the maximum available credit. If the "borrowing capacity" of the new arrangement is greater than or equal to the "borrowing capacity" of the old arrangement, the EITF states that, "any unamortized deferred costs, any fees paid to the creditor and any third-party costs incurred should be associated with the new arrangement (that is, deferred and amortized over the term of the new arrangement)".

Issue 3. What criteria can be developed for determining whether a replacement is between contracts that are substantially similar.

EITF 96-19 suggests that the present value of cash flows is the appropriate criterion, for debt instruments, in determining debt contracts that are substantially similar. As discussed in our Summary Comments above, determining future cash flows on a debt instrument is much simpler and easier to apply in practice due to the fixed terms and payments generally accompanying debt instruments. Insurance contracts tend to be more complex, with fixed or variable terms, fixed or variable payments, embedded optionality and uncertainty with respect to the timing of payments. The complexity and uncertainty associated with insurance contracts does not lend itself to the use of cash flows as the criterion for determining contracts which are substantially similar. Furthermore, debt instruments generally are replaced by another debt instrument of similar terms. Insurance contracts can be replaced by new contracts of similar terms, but may also be replaced by insurance contracts with very different terms. The differences in the types of insurance contracts or products is not contemplated by EITF 96-19.

We recommend the criteria presented in the following decision tree be considered as an appropriate model for determining whether two insurance contracts are substantially similar. The decision tree focuses first on whether the original contract is being replaced by a contract that is opposite in duration (short vs. long as defined by SFAS No. 60, *Accounting and Reporting by Insurance Enterprises* ("SFAS 60")). We believe the differences between a long and short duration contract constitute a substantially different contract. If a long duration contract is replaced by a long duration contract, SFAS 97 defines classes of contracts which could be considered substantially different. For example, a universal life contract replaced by an investment contract would constitute substantially different contracts. If the new contract is of the same class and duration as the original contract, we believe a difference of greater than 10% in discounted estimated gross profits, as defined by SFAS 97, similar to EITF 96-19, indicate the contracts are substantially different. If the original contract is an investment contract or universal life-type contract, as

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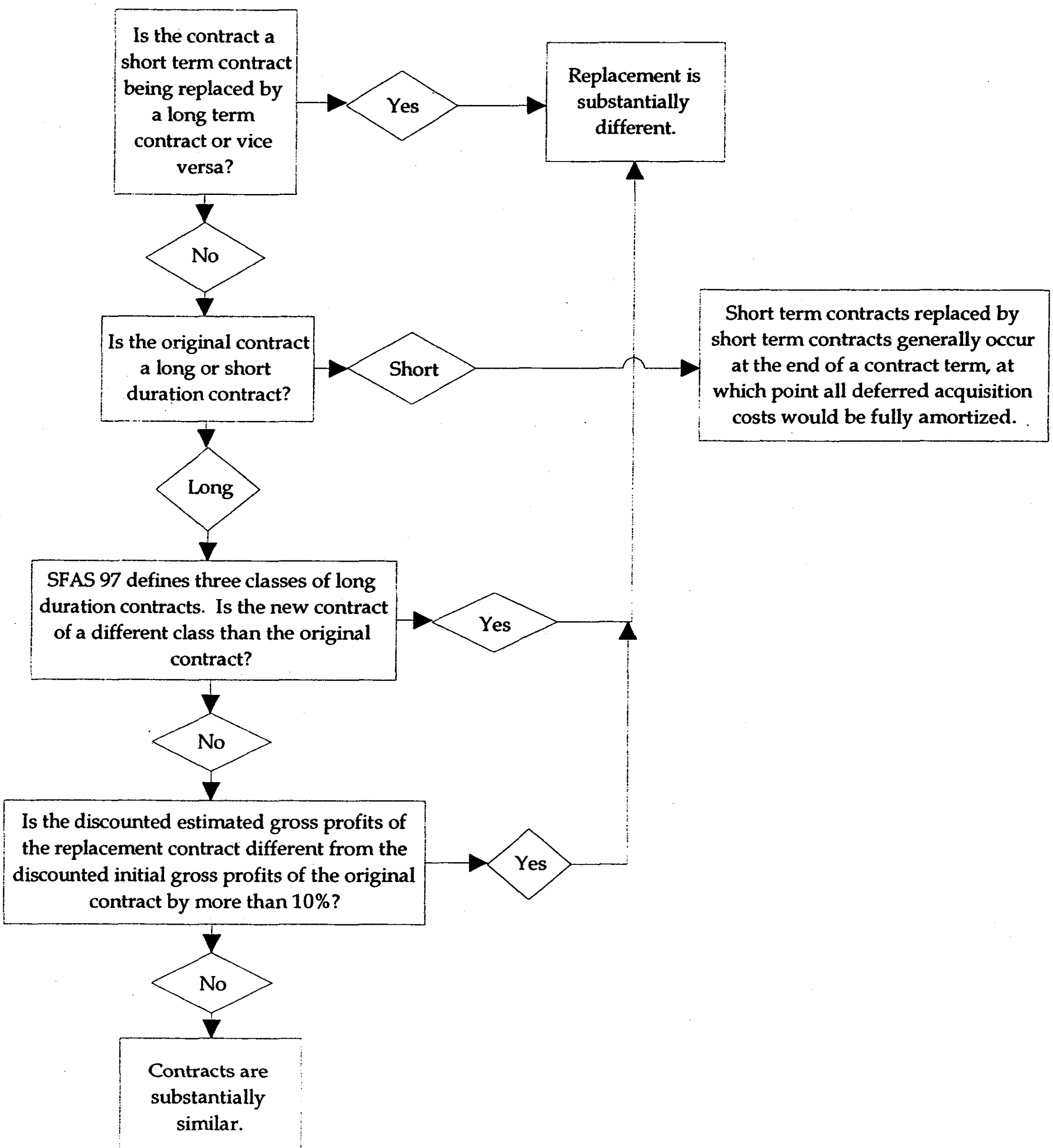
defined by SFAS 97, then the estimated gross profits to be used for the original contract should be the same as those used in the current deferred acquisition cost amortization schedule for that contract. The new contract's estimated gross profits should be determined consistent with the requirements of paragraph 23 of SFAS 97. (Note that the decision tree presumes that the policyholder does not change. If the policyholder changes, the replacement would be substantially different.)



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Issue 4. What costs (if any) should be considered as eligible costs for deferral in a replacement transaction.

Costs eligible for deferral in acquiring an insurance contract are defined and described in paragraph 28 of SFAS 60 and paragraph 24 of SFAS 97. Paragraph 28 of SFAS 60 states, "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." Paragraph 24 of SFAS 97 adds, "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." Given these definitions, we interpret replacements to be analogous to renewals; therefore, costs meeting the deferral requirements of SFAS 60 and SFAS 97 would be eligible for deferral in an internal replacement transaction. We would not expect any changes or expansion to these definitions.

EITF 96-19 describes that fees paid by the debtor to the creditor, or received by the debtor from the creditor in a non-debt extinguishment situation, "are to be associated with the replacement or modified debt instrument and, along with any existing unamortized premium or discount, amortized as an adjustment of interest expense over the remaining term of the replacement or modified debt instrument using the interest method." The EITF further states that costs incurred with third parties, in a non-debt extinguishment situation, "should be expensed as incurred". This notion seems inconsistent, however, with SFAS 60's definition of acquisition costs and their deferral. An internal replacement could be analogous to a renewal and therefore costs incurred with third parties, namely agents, in a replacement, would be deferred in accordance with paragraphs 28 and 29 of SFAS 60. A further inconsistency is described in our response to Issue 3. EITF 98-14, in certain situations, allows deferral of the unamortized costs of the "old" line-of-credit <u>and</u> allows deferral of costs incurred with third parties in connection with modifications or exchanges of a line-of-credit or a revolving-debt arrangement. Additionally, since the amortization method is defined, for DAC, by SFAS 97 or SFAS 60, those methods would be more appropriate than the interest method suggested in EITF 96-19.

We recognize that under our proposed approach it would be possible to capitalize two layers of DAC with respect to a replacement that is considered substantially similar. Under EITF 96-19, by contrast, it would not be possible to capitalize two layers of debt issuance costs for a replacement that is considered substantially similar. We believe this different result is supportable based on the provision in Statement 60 requiring capitalization of DAC for renewals. Under Statement 60, a renewal commission might be paid and capitalized in addition to unamortized DAC from the original issuance.

Issue 5. What other issues or practical considerations should be examined related to this topic.

Generally, acquisition costs associated with investment contracts or universal life-type contracts are aggregated by block of business, plan code or issue year, not on an individual contract by contract basis. This record keeping presents the most challenging consideration with respect to implementing an internal replacement model as described in our response to Issue 3. If acquisition costs were tracked on an

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individual by individual contract basis, like costs associated with debt instruments, it would be easy to identify costs associated with a replaced contract and be able to carry those costs to the new contract. Since acquisition costs are aggregated, replacement situations to date, where costs associated with the old contract are written off, result in an adjustment to the DAC amortization model for the actual experience of a "surrender", in effect. The new contract becomes part of an aggregation of newly issued insurance contracts. In an internal replacement situation, where the DAC associated with the original contract is to be carried to the new contract, the impact to the original contract's amortization model from a replacement or "surrender" would need to be calculated or modeled separately from other actual activity during the year. This separate calculation should result in the identification of the remaining unamortized DAC to be included in the new contract's aggregated DAC asset.

Issue 6. The Insurance Companies Committee would like to further investigate the analogy between internal replacements and modification or exchanges of debt instruments as it relates to deferral of costs (see View C). To do that, the following areas need further exploration.

- **What are the criteria that should be used to measure whether an internal replacement is between contracts that are substantially similar (or different)?**
- **If an internal replacement is between contracts that are substantially similar, what costs should be deferred? If commissions paid to agents or brokers are incurred, is it appropriate to defer those in light of the guidance in EITF 96-19.**

We refer you to our responses, comments and thoughts on these issues in our responses to Issues 3 and 4.

We would be pleased to discuss our comments with the ICC, a developed task force or AcSEC at their convenience.

Very truly yours,

Ben Neuhausen
Arthur Andersen LLP

American Council of Life Insurance

Stanton L. Cole
Actuary

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9-29-99

September 29, 1999

Ms. Elaine M. Lehnert
Technical Manager
Accounting Standards, File 3162
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Invitation to Comment, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97*

Dear Ms. Lehnert:

The Generally Accepted Accounting Principles Committee (the Committee) of the American Council of Life Insurance (ACLI) appreciates the opportunity to provide its comments about the above Invitation to Comment. The ACLI is the principal trade association of life insurance companies, and its 493 members represent, in the aggregate, 82.3 percent of the assets of all domestic life insurers.

With respect to whether accounting guidance is needed on accounting by life insurance enterprises for deferred acquisition costs (DAC) on internal replacements other than those covered by FASB Statement No. 97, the Committee believes that while some diversity in practice exists, it is unaware of any significant problems related to such diversity. Accordingly, we do not see the need for any additional guidance at this time. If guidance were to be developed, however, we would disagree with any position that would always require the write-off of existing unamortized DAC in cases of internal replacements.

Rather, we believe that there are circumstances where it might be appropriate to retain the unamortized DAC related to the original contract based on an evaluation of the specific terms of the contracts and whether recoverability tests are met.

We thank you for giving the Committee the opportunity to comment on the Invitation to Comment and would be pleased to discuss our comments with the AICPA or its staff at their convenience.

Sincerely,

Stan Cole

Stanton L. Cole

SLC:jmb

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Author: MIME:TODDH@hascal.com at INTERNET
Date: 9/23/99 4:48 PM
Priority: Normal
TO: Elaine M. Lehnert at AICPA3
Subject: Discussion Paper re FASB No. 97

Dear Elaine-

We have read and discussed this paper. Although the members of our committee do not have the expertise regarding the insurance industry to comment as you would have liked, we did want to respond as follows.

Based on issues the Insurance Companies Committee wants comments on and the various view points offered for discussion, it appears to us that there is a need to provide standards for replacements beyond the narrow constraints of FASB 97, ie universal life policies.

Todd H. Hangen, CPA
Member of the Washington State Society
Accounting, Auditing and Review Standards Committee

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4 October, 1999

Ms. Elaine M. Lehnert
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Accounting Standards, File 3162
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

Re: Comments on the Discussion Paper, *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97*

Dear Ms. Lehnert:

PricewaterhouseCoopers LLP (PwC) appreciates the opportunity to comment on the Insurance Companies Committee of the American Institute of Certified Public Accountants' ("the Committee") discussion paper concerning *Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97* ("the paper").

We support the Committee's effort to explore the need for additional authoritative guidance regarding the treatment of deferred acquisition costs on internal replacements other than those addressed by 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.*

Attached are our responses to the issues raised in the paper.

*****

We appreciate the opportunity to express our views. If you have any questions regarding our comments, please feel free to contact Donald Doran at (973) 236 7214 or Mary Saslow at (860) 240 2036.

Sincerely,

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

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Issue 1:

Whether authoritative guidance is needed on the accounting by life insurance enterprises for deferred acquisition costs (DAC) in situations characterized as internal replacements.

We believe that there is a need for additional guidance on accounting for the deferral of DAC on internal replacements. AICPA Accounting Standards Division Practice Bulletin 8 (PB-8), *Application of 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, to Insurance Enterprises*, specifically states that FASB Statement No. 97 only addresses the replacement of a traditional life insurance policy with a universal life policy. FASB Statement No. 97 does not address accounting for such internal replacements as a universal life type policy for another universal life type policy, Statement of Position 95-1 (SOP 95-1), *Accounting for Certain Insurance Activities of Mutual Life Insurance Enterprises*, policies to FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises,* policies, or the replacement of an investment type annuity with another investment type-product. In regard to these other types of replacements, PB-8 merely states "the accounting for other internal replacements should be based upon the circumstances of the transaction." This guidance is vague and has led to diversity in accounting policies and financial results. We believe that this diversity would be mitigated through additional guidance on the accounting for internal replacements under generally accepted accounting principles (GAAP).

Issue 2:

Which of the views presented herein is most appropriate and whether there are other views that should be considered.

We do not believe that View A is the most appropriate as we believe that there may be certain situations where the continued deferral of remaining DAC on the old policy after the replacement may be appropriate. View A would not permit a deferral in any situation.

We do not believe that there is any GAAP precedence for View B. The Financial Accounting Standards Board rejected the concept of DAC representing customer relationships in paragraphs 70 through 72 of FASB Statement No. 97. DAC represents the acquisition costs of a contract. While we can see the logic for the continual deferral of original costs when one policy is replaced by a policy that is substantially the same in form, risk and coverage, we believe that original costs should be expensed at the time the original policy is replaced by a contract that is substantially different (i.e., produces significantly different economic results) than the original policy.

We believe that View C is the most appropriate method for addressing the deferral of original DAC on replacement contracts. As a life insurance product is similar to a long-term liability (i.e., the insurance company has a long-term obligation to a third party), we believe that guidance provided in FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* and Emerging Issues Task Force Issue No. 96-19 (EITF 96-19), *Debtor's Accounting for a Modification or Exchange of Debt Instruments*, concerning the exchange of debt in a nontroubled debt situation can be used as the basis for developing GAAP accounting for replacement contracts.

Consistent with the guidance for debt extinguishment contained in EITF 96-19, we believe that it would be appropriate, assuming recoverability tests have been met, for original DAC to continue to be deferred when the original policy is replaced by a policy that is substantially similar to the contract being replaced. However, we believe that original DAC should be expensed currently if the replacement contract is substantially different than the contract being replaced.

Issue 3:

What criteria can be developed for determining whether a replacement is between contracts that are substantially similar.

The nature of the coverage provided. Does the policyholder receive the same type of benefit under both contracts (e.g., a replacement of a life insurance policy to one which provides long-term care should automatically be considered "substantially different")?

The economics of the contract. Is the insurer in a substantially different economic position as a result of the new contract compared to the old? This would require a definition and criteria for "substantially different" as well as agreement to the appropriate "economics" that should be used as a benchmark. If the types of margins, such as investment, mortality, or expense, have shifted between the policyholder and the insurance company, then that could be an indicator of "substantially different".

The accounting for the contract. Is a FASB Statement No. 97 contract being replaced with a FASB Statement No. 60 contract? We believe that if existing GAAP accounting already requires different GAAP treatment for the two policies, then that replacement automatically defaults to "substantially different."

If the above three criteria for being "substantially similar" are met, then a 10% present value cash flow test, similar to that prescribed by EITF 96-19, should be applied to the cash flows between the insurance company and the policyholder for determining "substantially similar."

Issue 4:

What costs (if any) should be considered as eligible costs for deferral in a replacement transaction.

The costs deferred should depend upon the nature of the contract. If the product qualifies for accounting under FASB Statement No. 60 then the costs that vary with and are primarily related to the acquisition of the replacement contract (e.g., commissions, underwriting costs, and any other costs incurred to replace the old contract with the new) should be deferred. If the new contract falls under the accounting provisions of FASB Statement No. 97, then the same type of acquisition costs as described in FASB Statement No. 60 should be deferred except for those costs that "vary in constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount."

Unamortized DAC associated with an original policy replaced by a contract that is substantially similar to the original contract should also continue to be deferred in addition to DAC associated with the replacement contract.

Issue 5:

What other issues or practical considerations should be examined related to this topic.

If a replacement contract is deemed to be substantially similar to the original, then what is the proper period over which the original DAC should be amortized? Is it appropriate to amortize the original DAC over the entire period of the new contract or should the old DAC continue to be amortized over the period of the original contract?

If a replacement contract is deemed to be significantly similar to the original contract, then DAC associated with the replacement contract along with any existing DAC should be amortized over the period covered by the replacement contract. Following the rational that a "substantially similar" replacement contract is really just a modification of the old contract, then the change in the amortization period should be treated as a change in estimate under the provisions of Accounting Principles Board Opinion No. 20, *Accounting Changes*. Accordingly, we believe that it would be appropriate to amortize remaining original DAC over the new policy period for FASB Statement No. 97 contracts. If the original contract is a FASB Statement No. 60 contract, however, DAC must continue to be amortized over the original contract period due to the "locking" of the persistency assumptions in FASB Statement No. 60 contracts.

For some products, DAC is calculated on the book of business. Is it practical to reduce DAC down to the policy level?

If it is determined that an internal replacement to a FASB Statement No. 60 product qualifies for substantially similar contract treatment and unamortized DAC is kept on the books, should the entire transaction be considered a continuation of the original contract and no premium revenue recognized for the transaction unless new cash is received in the year? We believe that if DAC is carried forward, then the entire transaction should be treated consistently, that is, premium revenue should not be recognized unless new cash is received at the time the replacement contract is issued.

There may be a need to clarify that a conversion in accordance with terms of the original contract would not be considered a replacement and should not be treated as a new sale. Existing DAC should remain on the balance sheet and premium revenue not be recognized for the transaction unless new cash is received at the time the replacement is issued.

In regard to the analogy between internal replacements and modification or exchanges of debt instruments as it relates to deferral of costs:

Issue 6a:

What are the criteria that should be used to measure whether an internal replacement is between contracts that are substantially similar (or different)?

We believe that further investigation into the nature and economics of the replacement used to evaluate an insurance contract may be warranted. There should be consideration of the various risks assumed by the policyholder and the insurance company (such as investment, mortality or expense), both before and after the replacement. If these criteria are met, then we believe that the present value cash flow approach described in EITF 96-19 would be a good tool for evaluating whether an internal replacement is substantially similar to or different from the replaced contract. We understand there is diversity in opinions on whether, due to the inherent differences between a debt agreement and an insurance contract as well as the differences in the relationships between the parties involved, the model and 10% criteria established for determining whether a debt instrument exchange involves substantially different products is appropriate for evaluating insurance replacement contracts. There may be a need to provide guidance on the application of the 10% criteria when investment risk is assumed by the policyholder.

Issue 6b:

If an internal replacement is between contracts that are substantially similar, what costs should be deferred? If commissions paid to agents or brokers are incurred, is it appropriate to defer those in light of the guidance in EITF 96-19?

Under the provisions of EITF 96-16, third party costs incurred in the exchange or modification of debt are expensed as incurred. We do not believe this is appropriate for insurance contracts. Traditionally, commissions have comprised a significant portion of DAC. FASB Statement No. 60 requires that the costs that vary with and are primarily related to the acquisition of the replacement contract (e.g., commissions, underwriting costs, and certain other costs incurred to replace the old contract with the new) should be deferred. We believe that the guidance in FASB Statement No. 60 and FASB Statement No. 97 regarding deferrable expenses should be applied to third party expenses associated with replacement contracts.

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AMERICAN ACADEMY *of* ACTUARIES

DATE: September 29, 1999

TO: American Institute of Certified Public Accountants

FROM: Daniel J. Kunesh — American Academy of Actuaries

RE: COMMENTS ON JUNE 25, 1999 DISCUSSION PAPER "ACCOUNTING BY LIFE INSURANCE ENTERPRISES FOR DEFERRED ACQUISITION COSTS ON INTERNAL REPLACEMENTS OTHER THAN THOSE COVERED BY FASB STATEMENT NO. 97"

The American Academy of Actuaries' Committee on Life Insurance Financial Reporting (COLIFR) appreciates the opportunity to comment on the above-referenced document (Discussion Paper). Our attached comments are intended to be consistent both with the language and intent of the discussion contained in the Discussion Paper.

COLIFR appreciates the complexity of some of the issues involved and welcomes correspondence and discussion about the matters raised in the attached commentary and any other matters your Task Force may wish to discuss with us.

The American Academy of Actuaries is the public policy organization for actuaries practicing in all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal elected officials, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualification and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

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TO: American Institute of Certified Public Accountants

FROM: The Committee on Life Insurance Financial Reporting of the American Academy of Actuaries

DATE: September 29, 1999

RE: Comments on AICPA Discussion Paper "Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those Covered by FASB Statement No. 97", dated June 25, 1999

Issue 1: Is authoritative guidance needed on the accounting by life insurance enterprises for deferred acquisition costs (DAC) in situations characterized as internal replacements?

- Guidance is needed to promote consistency of practice. The statement in paragraph 19 of Practice Bulletin 8 that "the accounting for other internal replacements should be based on the circumstances of the transaction" does not do much for consistency of practice.

- Practice Bulletin 8 does not elaborate on why continued deferral is not appropriate when traditional contracts are replaced with universal-life type contracts but may be appropriate in other circumstances. Any new guidance offered should try to address this.

- Notable diversity of practice is found in internal replacement programs in Europe (under US GAAP), in updates and upgrades of accident and health coverage in the US, and in the US life and annuity markets.

- This is an increasingly important issue as companies introduce new products, implement retention programs, and focus on customer profitability.

Issue 2: Which of the views presented herein is most appropriate? Are there other views that should be considered?

- We support the conclusion that continued deferral of DAC *may be sometimes appropriate*, and therefore disagree with View A. View A, expressed in Paragraph 8 of the Discussion Paper, appears to have an internal inconsistency. It indicates that the write-off of costs should be extended by analogy to all types of replacements, which we interpret as no opportunity to carry-over costs in any situation. Paragraph 10, however, suggests that FASB's restriction in Statement 97 was appropriate to the products then under discussion, and may not be reflective of the FASB's views on other kinds of replacements. We interpret this statement to suggest there may be situations where carry-over is appropriate.

- Both View B and View C conclude that continued deferral of DAC *might be sometimes appropriate.*

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- The criteria for eligibility for deferral treatment is the balancing issue. View B hinges on the view that the "internal replacement transaction represents a continuation of a contractual relationship" between the insurer and the insured. This logic has a great deal of appeal.

- We support View B for the following reasons:

  1. An internal replacement program is generally designed to preserve or improve the ongoing economics of the customer relationship; these programs have become an integral part of the product development cycle.
  2. The ability to carry-over amounts in a replacement situation creates an accounting model consistent with the economic motives of the replacement. A reported GAAP loss during the period that the relationship with the customer has been changed or extended is inconsistent with the economic reality of the transaction. Thus, carrying over the original DAC would avoid the inconsistent pattern of gains, followed by a loss in year of replacement, followed by gains.
  3. The flexibility of today's insurance contracts already allows modification of the company-customer relationship. A replacement may be a more visible modification, but in substance can often be similar to flexible transactions allowed within a contract.

- View C looks to the <u>terms</u> of the initial and replacement contracts as the chief criteria for eligibility for deferral of DAC. These criteria could be useful in a larger context, which recognizes the nature of insurance obligations and risks.

- It should be noted that debt instruments, which serve as the replacement model for View C, have markedly different underlying obligations and risks compared to insurance. Debt is an obligation between two sophisticated corporate entities. The exchange or modification of a debt instrument is often under terms that are negotiated between the parties to the debt. In contrast, an insurance replacement program operates between an insurer, who defines the terms of the replacement program, and the insured individual, who has the option to elect the new arrangement or stay with the original contractual guarantees. The risks underlying debt include default risk and credit risk. By contrast, insurance risks are distinct and broader ranged. This is discussed more under Issue 6 below.

Issue 3: What criteria can be developed for determining whether a replacement is between contracts that are substantially similar?

- Basic guidance could preclude crossover between lines of coverage, e.g. between life insurance / annuities / accident and health.

- Significant differences between the covered contingencies of the old and new contracts may also preclude replacement classification. This could, for example, prohibit crossovers between major medical / hospital / Medicare supplement / cancer / long term care and other similar coverage.

- The members of our committee share differing views on whether a change in GAAP classification should call for treatment as a new contract. A classical example is an annuity contract that has two phases (accumulation and payout) and may be classified as a SFAS 97 contract in the accumulation phase and a SFAS 60 contract in the payout phase.

- The guidance should provide specific criteria for deciding whether an internal replacement program should be accounted for as the continuation of an existing insurance program or as the issuance of a new block of business. For example, the replacement of one SFAS 60 contract with another may clearly qualify as an internal replacement for accounting purposes if certain criteria are satisfied. Examples of reasonable criteria are provided under Issue 5 below.

Issue 4: What costs (if any) should be considered as eligible costs for deferral in a replacement transaction?

- All costs that meet the SFAS 60 criteria of variability and attribution should be considered – agent compensation, commissions or agent bonuses for assisting in the replacement process, policy reissuance costs, any underwriting costs for an increase in the risk assumed by the insurer.

- Additionally, consideration should be given to any costs associated with making a replacement offer to existing policyholders, such as a mailing describing the offering.

- Arguably, inducements offered to policyholders as an incentive to replace one contract with another might be considered. These include bonus interest credits, premium credits and discounts.

- Any difference between the previous net GAAP reserve and the cash value transferred (which may include waiver of a surrender charge) should be considered. This difference may result in the deferral of a gain or loss, depending on the relationship of the net GAAP reserve to the transferred cash value. Alternatively, the deferred amount could be broken into its two components: the unamortized portion of DAC on the old contract plus the difference in benefit reserve on the old contract and cash value transferred.

- One option could be to limit combined (carryover and new) amounts deferred to an amount that would otherwise accrue to a new contract. Alternatively, we may suggest the newly replaced contract has a profitability profile no less than that of a similar, newly issued contract. In other words, amounts deferred may be further limited due to other factors, such as the impact on mortality margin in a replacement situation where no underwriting is done.

Issue 5: What other issues or practical considerations should be examined related to this topic?

- DAC is often valued on a block of business, rather than contract by contract, basis. Some guidance may be needed as to how to allocate unamortized DAC among contracts when continuing deferral after an internal replacement.

- According to paragraph 16 of the Discussion Paper, EITF 96-19 concluded that old and new fees deferred when a transaction "is not accounted for as debt extinguishment" should be

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amortized over the remaining term of the replaced debt. This might be difficult in internal replacement situations. Likewise it may be administratively impossible to amortize old amounts over the old term and new amounts over a new term. It would be more practical to allow amortization of old and new amounts over a term appropriate to the new contract.

- There are a number of transactional characteristics that can help to distinguish a "replacement" from a "new" contract. Examples are the benefits provided, the level of commissions or other acquisition costs relative to a new contract, and marketing circumstances, such as an offer limited to existing policyholders only. Reasonable evidence for treatment as a replacement would be similarity of benefits provided, a reduction in commissions or other acquisition costs relative to a new contract, and an offering limited to existing policyholders only. Other evidence could include simplified or no new medical underwriting, the manner in which the replacement policy is handled in the administrative system, and in some cases, original policy dating. However, a company's inability to identify the original policy date in its administration system should not preclude treatment as a replacement if other evidence clearly indicates a replacement.

- Examples will be needed in the guidance as to qualifying and non-qualifying internal replacement situations.

- Guidance on the required similarity of the replacement product to the original product will be needed.

- Guidance is needed on whether or not historical profit margins need to be considered in the amortization of DAC for replacement products that are subject to ongoing unlocking due to experience – SFAS 97 investment and universal life-type contracts, and SOP 95-1 participating contracts. The inclusion of historical profit margins in DAC amortization can present a number of practical problems, which suggest that a prospective-only approach may be the only feasible solution. A purist approach would require a policy-level backcasting of old product profit margins appended to a forecast of expected replacement product profit margins. However, very few companies are able to capture estimated profit margins at the policy level. Most companies perform DAC amortization at an aggregate level.

- The guidance should anticipate areas of potential abuse. For example, a company may be in a situation where a product with 100 bp margin can replace an old product with initial expectations of a 200 bp profit margin and revised expectations of 100 bp of profit margin. The old product, in the absence of replacement, would have experienced an acceleration of DAC amortization that could have led to GAAP losses. Replacement with a newer, more competitive product could mean that there is no DAC write-down, if amortization is to only consider future product revenue (premium, profits or margins). In the absence of other circumstances, such a company may be motivated to encourage policy replacement to avoid a DAC write-down.

- In setting guidance to avoid abuses, certain other questions should also be considered by the AICPA. Should an increase in the DAC balance for a replacement policy be limited, due to a revision in the expectations for future profits? Could the carryover of a DAC balance from

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one contract to another lead to a permanent DAC? Could replacements be used as a means of extending the amortization period?

- We believe that most replacement programs are initiated for reasons other than accounting result and an ability to avoid losses or delay DAC amortization. Accordingly, we believe the potential for abuse should not by itself preclude the carry over of DAC in true replacement situations.

Issue 6: The Insurance Companies Committee would like to further investigate the analogy between internal replacements and modification or exchanges of debt instruments....

- The analogy between internal replacements and modifications or exchanges of debt instruments is carried too far. There is some similarity between a company's responsibility to an insured in its contractual promise of benefits, given the occurrence of the covered risk(s), and that of a debt between a lender and borrower. However, the nature of the risks is different (credit and default risk vs. insurance risk). Furthermore the reasons for restructuring a debt are generally quite different than the reasons that a company endorses its internal replacement program. These are ignored by the FASB in its discussion in paragraph 72 of SFAS 97 and in the Discussion Paper, in paragraphs 13 through 17. The Discussion Paper presents the analogy without analysis of the nature of the risks or the reasons for the transactions.

- Of particular concern is the analogy drawn to EITF 96-19 and the 10% difference in the present value of the cash flows as the criteria for "substantially different". As stated earlier, debt and insurance contracts, while similar in some respects, are still quite different. Many of the health updates result in an improved product structure, for a higher premium. It is possible that many or most would fail the 10% test, if imposed on insurance internal replacement situations.

- According to paragraph 16 of the Discussion Paper, EITF 96-19 concluded that "costs incurred with third parties....should be expensed as incurred." This sounds onerous in the context of insurance transactions. Are agents third parties? What about medical information providers?

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January 5, 2000

Ms. Kim K. Hekker, CPA
Accounting Standards File 3162
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, New York 10036-8775

Dear Ms. Hekker:

Discussion Paper: "Accounting by Life Insurance Enterprises for Deferred Acquisition Costs on Internal Replacements Other Than Those covered by FASB Statement No. 97"

We appreciate the opportunity to provide comments on the Discussion Paper. KPMG believes that authoritative guidance is needed regarding the accounting by life insurance enterprises for deferred acquisition costs in situations characterized as internal replacements. Authoritative guidance would reduce the diversity in current practice and provide more comparable financial information for life insurance enterprises. The consistent application of accounting principles for these transactions would improve the ability of companies to operate on a level playing field.

In the basis for conclusion to 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* ("Statement 97"), the FASB stated that the related acquisition costs follow the contract, not the continuing relationship with the customer. In addition, the FASB recognized that the objective of these transactions was often to retain the customer base. Paragraph 72 further states: "That objective is not, however, different from the objectives of similar transactions undertaken by insurance enterprises and other enterprises for which continued deferral of costs is not permitted, including the refunding of debt." In the basis for conclusion to Statement 97, the FASB goes on to reference specific paragraphs in the conclusion of APB Opinion No. 26, *Early Extinguishment of Debt* as amended by FASB Statement No. 76("APB No. 26"). Paragraph 19 APB No. 26 is quoted in paragraph 72 of Statement 97, stating that "all extinguishments of debt are fundamentally alike." Paragraph 20 of APB No. 26 required that the difference between the carrying amount of the extinguished debt and the

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reacquisition price be recorded currently in earnings. The FASB's conclusion to write off the unamortized acquisition costs related to the replaced contract in paragraph 26 of Statement 97 was based on the then current literature on accounting for debt extinguishment.

In September 1996, the EITF began discussion on Issue 96-19, *Debtor's Accounting for a Modification or Exchange of Debt Instruments* ("EITF 96-19"). Since the FASB's conclusion on internal replacements in Statement 97, issued in December 1987 was developed with reference to the debt literature, we believe that subsequent interpretation of that literature in the form of EITF 96-19 would seem to be relevant to the accounting for internal replacements.

The FASB and EITF have concluded that substantial modification of terms of a debt instrument should be accounted for like, and reported in the same manner as, an extinguishment. Application of that principle to contracts issued by insurance enterprises would result in deferred acquisition costs being written off in connection with a modification that is sufficiently significant to constitute an extinguishment. The EITF explicitly stated that an exchange or modification of terms that does not result in a substantially different contract does not constitute an extinguishment. In such cases, the deferred acquisition costs related to the original contract continue to be amortized over the term of the replacement contract. Any new deferred acquisition costs incurred to achieve the modification would be expensed as incurred.

KPMG believes there is support in the accounting literature for View C. EITF 96-19 provided a cash flow test to determine when a replacement of one contract with another is substantially different. KPMG believes that a cash flow test analogous to that described in EITF 96-19 is appropriate only if such an approach could be operational for contracts issued by life insurance companies that are subject to internal replacement.

The issues summaries for EITF 96-19 document that the working group believed the approach for determining if a change or modification of terms of a debt instrument is substantially different should be "simple and straight-forward." The consensus of EITF 96-19 states: "From a debtor's perspective, an exchange of debt instruments between or a modification of a debt instrument by a debtor and a creditor in a nontroubled debt situation is a deemed to have been accomplished with debt instruments that are substantially different if the present value of the cash flows under the terms of the new debt instrument is at least *10 percent* different from the present value of the remaining cash flows under the terms of the original instrument.

The terms of contracts issued by insurance enterprises can differ significantly from the terms of debt instruments. Investment and insurance contracts often do not have a stated maturity or a stated interest rate. Contracts issued by insurance companies are basically due on demand, although surrender charges may be imposed as penalties for early withdrawal. Interest rates are often reset at the discretion of the company, which makes it difficult to determine an effective yield over the life of the contract. In addition, such contracts have various payment options on death or annuitization and different mechanisms to impose fees on the contractholder, such as cost of insurance charges and maintenance and expense charges. The unique features of these contracts may make it difficult to perform consistent cash flow analysis from company to company, given the extent of assumptions to be made in the cash flow analysis.

KPMG would support View C, as long as an operational approach can be developed for distinguishing between modifications that result in a substantially different contract and those that do not. In that regard, standard setters should consider not only quantitative indicators, but also whether changes in the qualitative characteristics of these contracts suggest that a modification of terms results in a substantially different contract. For example, if the replacement contract has variable terms and the original contract had fixed terms or if one of the contracts is deemed to be an insurance contract pursuant to Statement 97 and the other is an investment contract, then the replacement contract might be deemed to be substantially different. In many cases, we would expect that to induce the contractholder to agree to the internal replacement, a company needs to offer a significant economic benefit to the contractholder, which generally would mean that the replacement contract was substantially different from the original contract. However, we can envision certain limited circumstances where for administrative or regulatory purposes, such as offering a different array of investment options under a contract, companies will offer internal replacements that are not substantially different economically. In those cases, it would appear that the economics of the original contract remain in place and it would not be appropriate to write off the original deferred acquisition costs. Costs related to the new contract would then be charged to expense as incurred.

If operational criteria for assessing when a contract replacement is substantially different cannot be developed, KPMG supports View A. View A proposes that unamortized

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acquisition costs related to the original contract be written off at the time the original contract is terminated and the new contract is issued.

Costs eligible for deferral in a replacement contract are those costs that meet the definition of deferred acquisition costs pursuant to FASB Statement No. 60, "Accounting for Insurance." No additional guidance on this matter is needed in connection with the issue of internal replacements.

We appreciate the opportunity to comment on this Discussion Paper. If you have any questions concerning our comments or wish to discuss them further, please contact Ellen Hancock at 212-909-5626.

Very truly yours,

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