New Accounting Rule – To DAC or Not To DAC?

Effective this year, insurers must comply with a new Federal Accounting Standards Board (FASB) rule, “Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts” or ASU 2010-26. The update clarifies which costs can be amortized as deferred acquisition costs (DAC).

Changing the Definition of “Acquisition Costs”
Life insurers incur up-front acquisition expenses that can amount to multiples of the policy’s first-year premium. The FASB allows companies to capitalize these costs and amortize them over a schedule dependent on the products being marketed. The resulting DAC can be a substantial asset on carriers’ GAAP balance sheets.

Earlier accounting language defined DAC vaguely, describing such costs as those that “vary with and are primarily related to the acquisition of insurance contracts.” Companies were left to interpret which expenses qualified for deferral, leading to a broad range of expenses being categorized as DAC. Such costs have included producer compensation and bonus programs, underwriter compensation, medical exams, product development, office rent and supplies, training, new producer allowances, and marketing materials.

ASU 2010-26 addresses concerns that the ambiguity of DAC-able costs opened the DAC asset to abuse. The update also attempts to create comparability within the life insurance industry. This is similar to the FASB’s accounting rules for banks and their costing structure for loan activity.

ASU 2010-26 introduces two important changes:

The successful acquisition of new business. With the update, companies now may only defer costs associated with successful placement of business. In the past, carriers may have grouped all sales-related costs under DAC irrespective of placement, as declines were seen as integral to the sales process. Now, costs associated with not-takens or even insurer declines do not qualify as a DAC asset.

Directly attributable costs. Many insurers incur high fixed back-office costs to write new business. Underwriting is perhaps most notable, but other costs include product development, marketing and strategic planning. Under ASU 2010-26, only the portion of these costs that can be directly linked to top-line sales can be allocated as a DAC asset.

Business Implications

Earnings and Equity. ASU 2010-26 can affect business on both a look-back and going-forward basis. The rule allows for retrospective application to prior reporting years. In investment calls in late 2011 and early 2012, many prominent carriers announced that they would restate earnings for at least 2011.

Because many carriers are adjusting prior earnings reports to reflect DAC under ASU 2010-26, other companies may feel pressure to amend their past statements as well. Otherwise, the company will need to be able to...
explain the DAC, earnings and capital discrepancies between 2011 and 2012.

Retrospective application will require write-offs of DAC assets, some of which will be substantial. As executives have pointed out in earnings calls, this is not a cash charge: the costs being written off were incurred in the past. However, as the insurer has carried these costs as an asset on its balance sheet, it must write off a similar amount of capital and surplus. The liabilities do not change.

Going forward, more costs will be applied directly against the bottom line of the income statement under general expenses as fewer costs are capitalized. As a result, life insurer earnings could be lower and more volatile.

Sales. Commissions are paid only as sales are placed, so it would appear that most, but not necessarily all, producer sales compensation remains DAC-able (Figure 1). But the home office now will require information from the field on unsuccessfully placed cases as well as on those that were placed. This may require producers to spend more time on reporting paperwork and limit their time actually generating sales. Technology improvements can help in reporting (placement rates are captured in underwriting systems), but reporting procedures and codes for sales and accounting systems likely will need to be developed or updated.

A by-product of this may be increased producer selectivity in prospecting. This can be a double-edged sword: while producers may focus on more promising sales prospects, they also may avoid opportunities that are not as obvious. Both agents and their carriers could consequently lose business.

Underwriting. The underwriting department similarly will come under increased pressure. As mentioned above, an underwriter’s compensation is effectively a fixed cost. Defining their worth on the number or percentage of cases placed can be a shortsighted strategy. Increased focus on placement could introduce pressure on the underwriting team to stretch criteria beyond acceptable parameters or to increase the number of underwriting decisions. An effective underwriter, in fact, may have a lower-than-average placement rate due to conservative and reasonable application of the firm’s underwriting rules.

Given the pressures on sales and underwriting, we expect increased focus on placement rates. Overweighted focus on placement as a gauge of producer/underwriter performance could impair the quality of a block of business. Determining the right balance between placement and product performance could be a challenge.

Not All Bad News

Investment analysts have zeroed in on the effects that this rule change will have on the balance sheet. This is understandable, given the magnitude of restating capital and earnings to accommodate a retroactive application of the rule (Figure 2).

From a business perspective, though, a number of benefits may emerge. Peer analysis across the industry should become much easier, allowing stakeholders to have a clearer view of a firm’s performance. Company/industry expense studies and benchmarks may become more accurate and useful. Additionally, companies that have used DAC conservatively likely will see less capital and earnings disruption than those carriers that applied more liberal approaches.

Companies also will be allowed to realize immediately part of the costs that they previously amortized. While DAC is a valuable asset to many carriers, the deferred nature in itself depreciates the present value of these costs. DAC is a non-cash asset and does not earn income or interest. It is reported in current dollars, which are worth less than last year’s dollars. Reporting the cost in the period it is incurred marginalizes this implicit discount rate.

New strategies may be implemented to help maintain an acceptable placement rate that does not harm the quality of
business being written. For example, on the sales side we may see increased worksite marketing due to the ability to sell many products in one sitting. Companies may pursue more transaction-based products that cut turnaround time and improve applicant acceptance. Carriers may review producer compensation and incentives to recognize the value of persistency.

Underwriters actively look for opportunities to reduce the intrusion, time and cost of today’s fully underwritten processes without impairing risk classification. ASU 2010-26 may accelerate efforts to identify new mortality markers, leading to more collaboration between life insurers, reinsurers, labs and other vested partners.

**Conclusion**

The changes incorporated in ASU 2010-26 will bring more consistency to DAC, but with a price. For companies retroactively applying the rule to prior reporting years, the value of both the DAC asset and company equity will be affected substantially. Ongoing challenges will center on technologies to improve reporting and ensure compliance. Monitoring producer and underwriter results to ensure that the performance of the block remains within expected parameters also will be an ongoing effort.

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**Figure 2: New DAC’s Impact on Carrier Financials, 2012**

<table>
<thead>
<tr>
<th>Company</th>
<th>Balance Sheet Impact</th>
<th>Earnings Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% DAC Written Off</td>
<td>% Equity</td>
</tr>
<tr>
<td>A</td>
<td>-13.9</td>
<td>-5.7</td>
</tr>
<tr>
<td>B</td>
<td>-20.0</td>
<td>-11.1</td>
</tr>
<tr>
<td>C</td>
<td>-9.5</td>
<td>-5.4</td>
</tr>
<tr>
<td>D</td>
<td>-26.0</td>
<td>-10.1</td>
</tr>
<tr>
<td>E</td>
<td>-23.3</td>
<td>-7.0</td>
</tr>
<tr>
<td>F</td>
<td>-45.5</td>
<td>-14.1</td>
</tr>
<tr>
<td>G</td>
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<td>-24.9</td>
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<tr>
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<td>-1.3</td>
</tr>
<tr>
<td>J</td>
<td>-12.7</td>
<td>-7.5</td>
</tr>
</tbody>
</table>

The companies in this sample vary in size and business mix. The average DAC asset estimated to be written off this year is 22.8 percent, with an average decline in equity of 9.9 percent. (Source: “Insurance Primer 2012,” Morgan Stanley Research. Dec. 29, 2011.)