Statutory Issue Paper No. 71

levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of the premium payment or the maintenance of the agent's license with the reporting entity is not maintained with respect to the payment stream.

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

DISCUSSION

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

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

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

Drafting Notes/Comments

None

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting

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

> <u>Levelized Commission</u>
>
> The accounting treatment for certain transactions, characterized as levelized commissions, which results in enhancement of surplus, has been determined to be inappropriate for statutory reporting.
>
> These transactions are, in fact, funding agreements between an insurer and a third party. Agents receive normal (non-level) commissions with payments made by the third party. It is intended, but not necessarily guaranteed, that the amounts paid to the agents would ultimately be repaid (with interest explicit or implied) to the third party by "levelized" payments (which are less than the normal first year commissions but exceed the normal renewal commissions) from the insurer. The continuance of the stream of payments specified in the levelized commission contract is a mechanism to bypass recognition of those expenses which are ordinarily charged to expense in the first year of the contract. Consequently, the normal link between the persistency of the policy, the continuance of premium payment or the maintenance of the agents license with the insurer is not maintained with respect to the payment stream.
>
> The use of an arrangement where commission payments are not linked to traditional elements such as premium payments and policy persistency but rather are linked to the repayment of an advanced amount requires the establishment of a liability in the full amount of the unpaid principal and accrued interest.

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

> Financial statements should not reflect paid or incurred commissions on an earned premium basis, except for commissions based on loss experience. If commissions by contract are paid on an earned premium basis, but are not dependent on the loss experience of the insurance written, a reserve should be established for unpaid commissions. This reserve shall also be offset against "Agents' Balances or Uncollected Premiums".
>
> Commissions payable on reinsurance assumed business should be included as an offset to "Agents' Balances or Uncollected Premiums". Commissions receivable on reinsurance ceded business should be included as an offset to "Ceded Reinsurance Balances Payable", which are included in "Agents' Balances or Uncollected Premiums".
>
> Contingent Commission
>
> Some insurance companies, to encourage quantity and quality of production, or to penetrate a line of business or geographical area, will enter into special commission arrangements with some of their agents. The incentive for the selection of good risks is that the agent is allowed to share in the profitability of the insurance he produces. The terms of the arrangement usually will be set forth in a "contingency commission agreement", which is either incorporated as part of the agency contract or as a separate contract. The agreement will provide for the dates upon which accountings are to be rendered to determine the contingent commissions, items to be included in the calculation, and a provision for the calculation, if any, in the event the contract is canceled.
>
> The determination of the contingent commission liability is based upon the terms of the commission agreement. If the contract specifies that commissions will be determined on the basis of a formula that relates to loss experience, a commission liability must be established for the earned portion. The unpaid liability for commissions that are based upon loss experience should be included in a separate liability heading - "Contingent Commissions and Other Similar Charges".
>
> Some agency contracts provide for vesting of the agents' commissions for renewals or policy adjustments. The contract also may specify that the company will pay the agent for the commutation of commissions payable on future premium collections. Such payments must be included as a commission expense. If the company has incurred a liability to commutate an agent's commission at the balance sheet date, the liability should be included as an offset to "Agents' Balances or Uncollected Premiums".

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

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

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

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

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

Generally Accepted Accounting Principles

15. Statement of Accounting Concepts No. 6 establishes the following definition of an asset:

> 26. An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving ri

c. Amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances

d. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as surrender charges)

e. Other expected assessments and credits, however characterized.

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

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

RELEVANT LITERATURE

Statutory Accounting

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

Generally Accepted Accounting Principles

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

State Regulations

- No additional guidance obtained from state statutes or regulations.

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