



AMERICAN ACADEMY of ACTUARIES

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June 18, 2009

Financial Accounting Standards Board (FASB)  
401 Merritt 7  
P.O. Box 5116  
Norwalk, CT 06856-5116

Re: *Preliminary Views on Revenue Recognition in Contracts with Customers*

These comments are from the Financial Reporting Committee of the American Academy of Actuaries<sup>1</sup> concerning the Discussion Paper on Revenue Recognition (RRDP).

While we considered the overall issues addressed in the RRDP, we particularly considered the proposals from the perspective of how they would apply to insurance contracts. Since the RRDP doesn't address several important issues such as the handling of future rights under a contract and the time value of money, all our comments on the RRDP are tentative. Furthermore, since accounting for insurance contracts is an active project under development, our comments on the applicability of the RRDP to insurance contracts are also preliminary and are subject to change as a result of further discussion of accounting for insurance contracts.

Our primary concern in reviewing this paper is whether Insurance Contracts could or should be included in the scope of the eventual standard on Revenue Recognition (the RRS). While we believe there is significant benefit to including insurance contracts within the scope, we concluded a separate Insurance Contracts Standard (ICS) to give guidance for insurance-specific situations is still required. Furthermore, we concluded that if insurance is included under the RRS, either change would be needed in the Boards' tentative conclusions in the RRDP or specific clarifying provisions and possibly exceptions would have to be included in the ICS.

Enclosed are our detailed answers to the RRDP discussion questions. We thank you for the opportunity to comment.

Sincerely,

Rowen B. Bell  
Chairperson, Financial Reporting Committee  
American Academy of Actuaries

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<sup>1</sup> The American Academy of Actuaries ("Academy") is a 16,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

## Question 1

**Do you agree with the Boards' proposal to base a single revenue recognition principle on changes to an entity's contract asset or contract liability? Why or why not? If not, how would you address the inconsistency in existing standards that arises from having different revenue recognition principles?**

In general, we agree with the Boards' proposal to base a single revenue recognition principle on changes to an entity's contract asset or contract liability. We particularly like that the Boards propose recognizing and measuring the net contract asset as a whole rather than in pieces unless those pieces occur in different reporting periods. We agree strongly with those positions and urge that they be applied consistently to the measurement of an insurance contract.

For existing standards, it will clearly be necessary to review inconsistencies and assure that each of them is solved by the proposed principle.

## Question 2

**Are there any types of contracts for which the Boards' proposed principle would not provide decision-useful information? Please provide examples and explain why. What alternative principle do you think is more useful in those examples?**

We examined this question for insurance contracts and have concluded that it is too early to tell whether this principle works completely for them because a number of important issues are not addressed in RRDP. As we describe further below, we believe the Boards should change the position on remeasurement in the RRDP. Also as we describe below, we believe that adjustment should be allowed for measurement of multi-year contracts with front-end expenses. In addition, as noted in the RRDP, satisfactory guidance will be needed for how to treat future rights under a contract. We have suggestions for this later in this comment letter.

Furthermore, guidance will be necessary on how to treat the time value of money in calculations of revenue for multi-year contracts.

## Question 3

**Do you agree with the Boards' definition of a contract? Why or why not? Please provide examples of jurisdictions or circumstances in which it would be difficult to apply that definition.**

Yes, we think the definition is acceptable as far as insurance contracts are concerned. We offer no opinion on the more general question for all contracts.

## Question 4

**Do you think the Boards' proposed definition of a performance obligation would help entities to identify consistently the deliverables in (or components of) a contract? Why or why not? If not, please provide examples of circumstances in which applying the proposed definition would inappropriately identify or omit deliverables in (or components of) the contract.**

We think this definition is appropriate in general, but more specific guidance is needed for insurance contracts. We therefore would propose that the ICS clarify that insurance contracts provide the service of insurance risk coverage over the coverage period. Therefore, revenue for an insurance contract should be recognized over the risk period as that coverage is provided, even if the actual payment of a covered claim is made after the end of the coverage period. Such a pattern of revenue recognition is consistent with defining the performance obligation provided by insurance contracts as risk coverage. As of the end of the coverage period, the insurer estimates its liability both for known and for incurred but as yet unreported claims. Treatment of such post-claim liabilities should be addressed in the ICS.

We are concerned that the definition of performance obligation may not encompass at least one component of U.S. insurance contracts that can be material in certain situations. This component involves legal obligations to parties other than the customer that may arise out of insurance contracts, typically in the form of assessments payable to governmental and/or quasi-governmental agencies. Clarification should be provided in the ICS that such assessments are required as a result of the contract that provides the insurance coverage, and are included within the performance obligation to provide such coverage.

#### **Question 5**

**Do you agree that an entity should separate the performance obligations in a contract on the basis of when the entity transfers the promised assets to the customer? Why or why not? If not, what principle would you specify for separating performance obligations?**

Yes. This allows for the proper discount for time value of money (for multi-year contracts) and recognition of revenue by accounting period. For insurance contracts, it allows for recognition of revenue based on release from coverage risk under the contract. We believe this is the appropriate basis for recognizing revenue for insurance contracts.

#### **Question 6**

**Do you think that an entity's obligation to accept a returned good and refund the customer's consideration is a performance obligation? Why or why not?**

This is not typically a material issue for insurance contracts. When premium is returned, it is generally because coverage has also terminated and the returned premium is for coverage that will not occur. Therefore there is no revenue effect.

We emphasize that surrender benefits under long-term contracts are not a returned good but rather a part of the performance obligation.

#### **Question 7**

**Do you think that sales incentives (eg discounts on future sales, customer loyalty points and 'free' goods and services) give rise to performance obligations if they are provided in a contract with a customer? Why or why not?**

Yes, assuming the sales incentive has value. If provided for within a contract, these contingent payments are obligations of the company and revenue should be allocated to cover their potential costs.

## Question 8

**Do you agree that an entity transfers an asset to a customer (and satisfies a performance obligation) when the customer controls the promised good or when the customer receives the promised service? Why or why not? If not, please suggest an alternative for determining when a promised good or service is transferred.**

Yes. We believe this is the proper definition. For insurance contracts, the promised service is insurance risk coverage rather than transfer of any promised good. Therefore, revenue will be recognized as coverage is provided and as the insurer is released from coverage risk on the policy.

Recognizing insurance premium revenue as coverage is provided has the additional benefit that it would allow for recognition of revenue even in the event of favorable experience with no losses under a contract. A recognition criterion that requires a tangible good (e.g., a claim payment) to be transferred in order for revenue to be recognized is non-operative for insurance contracts that may not result in any claims for a given policy. For example, if an insurer provides hurricane coverage for 1,000 insureds in a particular area, but no hurricane occurs during the coverage period, the insurer should still recognize the revenue for providing the coverage that these insureds purchased. The revenue for providing such coverage for a particular period should not be affected by whether or not a hurricane actually occurs in that period.

## Question 9

**The Boards propose that an entity should recognise revenue only when a performance obligation is satisfied. Are there contracts for which that proposal would not provide decision-useful information? If so, please provide examples.**

Assuming that the performance obligation for insurance contracts is defined as we suggest, we believe this definition works well for most types of coverage. It may be necessary to clarify treatment for some kinds of insurance contracts within the ICS (e.g., policies with large deposit elements), in order to avoid anomalous results.

## Question 10

**In the board's proposed model, performance obligations are measured initially at the original transaction price. Subsequently, the measure of a performance obligation is updated only if it is deemed onerous.**

**a) Do you agree that performance obligations should be measured initially at the transaction price? Why or why not?**

We agree that the performance obligations should be measured at inception at the transaction price. This works well for the single consideration contracts discussed in the RRDP. For long duration insurance products, however, the performance of the obligation will typically occur over a number of accounting periods and the transaction price will also often be paid over these periods. The actual magnitude of the performance obligation will vary based on whether the policyholder pays or does not pay, and, for flexible premium contracts, on how much the policyholder pays. Therefore, in doing this calibration for recurring consideration contracts, the

initial transaction price should be measured as the present value of the anticipated future considerations (premiums).

The value of the performance obligation can conceptually be calibrated using the 3 building blocks in paragraph 5.9 to be consistent with the transaction price. The actuarial profession can provide guidance for using these building blocks in a way that will promote comparability between companies and provide important information concerning base assumptions and margins.

We agree that the current exit price approach is not a reliable (or often feasible) approach, because there generally are no observable markets on which to base an exit price.

**b) Do you agree that a performance obligation should be deemed onerous and remeasured at the entity's expected cost of satisfying the performance obligation if that cost exceeds the carrying amount of the performance obligations? Why or why not?**

We agree that a performance obligation should be deemed onerous and remeasured if the cost of satisfying the future performance obligations exceeds the carrying amount of that obligation. For insurance contracts, however, this evaluation should reflect the pooling of risks within a portfolio and not be measured on an individual risk basis. Experience at the contract level is not credible for contracts issued to individuals or for all but the largest group contracts. The test for whether a performance obligation is onerous should be based on a portfolio of contracts that are subject to broadly similar risks and managed together.

It is our view, moreover, that for insurance contracts, a performance obligation should be re-measured periodically even if it has not become onerous. The liability should be re-measured for market-observable financial inputs in a manner that is consistent with the re-measurement of invested assets that results from the current IASB/FASB Financial Instruments project. For non-observable inputs, it is our view that the inputs should be updated when there is compelling evidence that the inputs used in the past are no longer appropriate, and that re-measurement is expected to result in a material change in the liability. For example, life insurance policies written 20 years ago would be expected to have a level of mortality that is significantly different today from what was expected when the performance obligation was first measured. Material changes in inputs that are not market observable should be subject to separate disclosure as to the reason for the change and the evidence supporting the change.

**c) Do you think that there are some performance obligations for which the proposed measurement approach would not provide decision-useful information at each financial statement date? Why or why not? If so, what characteristic of the obligations makes that approach unsuitable? Please provide examples.**

We cannot name any performance obligations that should be subject to another measurement approach. This does not mean that no such performance obligations exist. Time and experience of all parties will give more reliability to this answer.

Also, subjecting different products to different measurement standards would typically result in accounting arbitrage as products are developed to achieve an accounting result rather than based on their fundamental markets. We believe it would be better to make the definition broad enough to cover all products rather than have an approach based on contract classification.

**d) Do you think that some performance obligations in a revenue recognition standard should be subject to another measurement approach? Why or why not? If so, please provide examples and describe the measurement approach you would use.**

No.

## **Question 11**

**The Boards propose that an entity should allocate the transaction price at contract inception to the performance obligations. Therefore, any amounts that an entity charges customers to recover any costs of obtaining the contract (for example, selling costs) are included in the initial measurement of the performance obligations. The Boards propose that an entity should recognize those costs as expenses unless they qualify for recognition as an asset in accordance with other standards.**

**a) Do you agree that any amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations? Why or why not?**

For insurance contracts, we do not agree that all amounts an entity charges a customer to recover the costs of obtaining the contract should be included in the initial measurement of an entity's performance obligations. Rather, we propose that expenses the insurance company incurs simultaneously with or immediately after obtaining the contract ("initial expenses") should be subtracted from the value of considerations at the time of sale when calibrating the value of performance obligations to the value of consideration.

The Appendix to this letter includes an illustration of our proposal compared to the treatment found in the RRDP and the treatment proposed in the wording of Question 11a above, for a hypothetical 5-year single premium term life policy.

**b) In what cases would recognizing contract origination costs as expenses as they are incurred not provide decision-useful information about an entity's financial position and financial performance? Please provide examples and explain why.**

Recognizing contract origination costs as expenses as they are incurred will not provide decision-useful information about an entity's financial performance for long duration contracts in periods when sales decline or increase from prior periods unless an adjustment is made as described in our response to Question 11a above.

As an example of the distortion that would occur when an entity's sales decline or increase, assume an entity sells a contract that provides services for 10 years and receives consideration of CU1000 per year per contract. Assume that its pricing margin is 5% - i.e., the expected cost of fulfilling its obligation is 95% of the consideration. Assume that contract origination costs payable upon contract initiation are CU300 and interest is 0%. Finally, assume that the entity has sold 100 contracts a year for each of the past ten years.

We now show income statements for year eleven based on three different sales scenarios for the eleventh year assuming contract origination expenses are expensed as incurred.

In Scenario 1 we assume that sales in the eleventh year are once again 100 contracts. In this scenario the business remains in a steady state with expiring contracts equaling new sales.

Scenario 2 shows the results if sales in the eleventh year decrease to 50 contracts from 100.

Scenario 3 shows the results if sales in the eleventh year increase to 200 contracts from 100.

	<u>Scenario 1</u>	<u>Scenario 2</u>	<u>Scenario 3</u>
Revenue	1,000,000	950,000	1,100,000
- Cost of fulfilling obligations	-950,000	-902,500	-1,045,000
- Contract Initiation costs	<u>-30,000</u>	<u>-15,000</u>	<u>-60,000</u>
Net Income	20,000	32,500	-5,000

In Scenario 2 the entity would report increased net income for no other reason than it experienced a decline in sales of contracts that are expected to be profitable. On the other hand, in Scenario 3 the entity would show a loss from increased sales of contracts that are expected to be profitable.

We do not believe that recognizing gains because sales of contracts that are expected to be profitable fall and recognizing losses because sales of such contracts increase provides decision-useful information to users of financial statements.

Under our proposal to subtract initial expenses from the value of consideration, the same three scenarios would produce the following results:

	<u>Scenario 1</u>	<u>Scenario 2</u>	<u>Scenario 3</u>
Revenue	970,000	921,500 <sup>2</sup>	1,067,000 <sup>3</sup>
- Cost of fulfilling obligations	-950,000	-902,500	-1,045,000
Net Income	20,000	19,000	22,000

We believe this represents a more faithful and decision-useful representation of the economics of the transactions.

## Question 12

**Do you agree that the transaction price should be allocated to the performance obligations on the basis of the entity's stand-alone selling prices of the goods or services underlying those performance obligations? Why or why not? If not, on what basis would you allocate the transaction price?**

This is a reasonable approach if the entity sells such performance obligations on a stand-alone basis. However, if this condition does not apply, allowing unconstrained management judgment might lead to potential manipulation of the revenue allocation.

See our answer to Question 13 below for what to do in this situation.

<sup>2</sup> 921,500 = (100 \* 9 \* 970) + (50 \* 1 \* 970)

<sup>3</sup> 1,067,000 = (100 \* 9 \* 970) + (200 \* 1 \* 970)

### Question 13

**Do you agree that if an entity does not sell a good or service separately, it should estimate the stand-alone selling price of that good or service for purposes of allocating the transaction price? Why or why not? When, if ever, should the use of estimated be constrained.**

In the event that an entity does not sell a good or service separately, it should calculate the value of each performance obligation using the value of its remaining expected cash flows under the contract. This will generally be the case for insurance contracts.

## Appendix

As a supplement to our response to Question 11a, we have prepared the following illustration of three alternative treatments for a block of identical 5-year single premium term life policies issued at the same time. The first alternative is the treatment in the RRDP and assumes no adjustment for initial expenses<sup>4</sup>. The second alternative assumes the treatment we recommend in our responses to Questions 11a and 11b. The third alternative is the treatment proposed in the wording of Question 11a. As can be seen, the choice of treatment has a material effect on earnings both in the first and later years. For simplicity, the illustration ignores the effects of time value of money.

### Cash Flow Assumptions (CU)

	1	2	3	4	5	Total
1) + Premium	1200					1200
2) – Benefits	50	90	125	150	185	600
3) – Expenses	25	25	25	25	25	125
4) – Commission.	<u>200</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>200</u>
5) Total (1-2-3-4)	925	-115	-150	-175	-210	275

### Alternative 1 - Customer Consideration Model as per Discussion Paper

6) Obligation for Yr (2+3)	75	115	150	175	210	725
7) Revenue (6*(1200/725))	124	190	248	290	348	1200
8) Profit (7-2-3-4)	-151	75	98	115	138	275
9) Reserve EOY <sup>a</sup>	1076	886	637	348	0	

<sup>a</sup>1200 – cumulative revenue already recognized (7)

### Alternative 2 – Subtract Initial Expenses from Value of Considerations to Calibrate (Recommended)

10) Obligation for Yr (2+3)	75	115	150	175	210	725
11) Revenue <sup>c</sup>	303	159	207	241	290	1200
12) Commissions (4)	200					
13) Profit (11-10-12)	28	44	57	66	80	275
14) Reserve EOY <sup>b</sup>	897	738	531	290	0	

<sup>b</sup> 1200 – cumulative revenue already recognized (11)

<sup>c</sup> 10\*(1000/725) + 200 for year 1

<sup>4</sup> Initial expenses as defined in our response to Question 11a as “the expenses the insurance company incurs simultaneously with or immediately after obtaining the contract”.

**Alternative 3 - Allow Performance Obligations to Include Initial Expenses**

15) Obligation for Yr (2+3+4)	275	115	150	175	210	925
16) Revenue (15*(1200/925))	357	149	195	227	272	1200
17) Profit (16-15)	82	34	45	52	62	275
18) Reserve EOY <sup>d</sup>	843	694	499	272	0	
<sup>d</sup> 1200 – cumulative revenue already recognized (16)						

Not making any adjustment (i.e. Alternative 1) would also force an entity to recognize a loss when it sells a contract that is expected to be profitable (for short, “profitable business”) but that has significant costs at issue. If sales are in a steady state, the resulting distortion to income for the entity may not be significant. However, if sales are increasing, the entity would be reporting substantial losses just as a result of selling profitable business. This would distort the reported performance of the entity. Likewise, if sales are decreasing, the entity would be reporting substantial gains just because sales of profitable business are declining, which would also distort reported performance. This would impact both long duration and short duration contracts; however, the distortion would be less significant for short duration contracts. Since the costs are recovered over a shorter period of time, the distortion would self-correct over a shorter period of time.

On the other hand, as shown in Alternative 3, including charges to recover initial expenses in the entity’s performance obligations could also distort its financial statement. It could result in a larger reported profit in the first year than in subsequent years; although this would still result in less distortion than would result from no adjustment at all.

Therefore, Alternative 2 is the recommended approach. Alternative 2 addresses the deficiencies with the method proposed in the DP (Alternative 1) without introducing the less significant distortions associated with Alternative 3.