Torchmark Corporation 3700 S. Stonebridge Drive P.O. Box 8080 McKinney, TX 75070-8080



Via Email: director@fasb.org

February 12, 2010

Mr. Russell G. Golden File Reference No. EITF090G FASB 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: Proposed Accounting Standards Update: Financial Services – Insurance (Topic 944) – Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (A consensus of the FASB Emerging Issues Task Force)

Dear Mr. Golden:

Torchmark Corporation is pleased to have the opportunity to respond to your request for comments on the above exposure draft ("the Update"). As the parent company of Liberty National Life Insurance Company, United American Insurance Company, Globe Life and Accident Insurance Company, American Income Life Insurance Company, and United Investors Life Insurance Company, insurance companies that specialize in life and supplemental health insurance with premiums exceeding \$2.6 billion, this is a relevant and significant issue for Torchmark Corporation.

Although the purpose of the proposed Update is to address diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify as deferred acquisition costs, this Update will also create further diversity in practice and comparability of financial statements among the insurance industry. In addition, considering a new insurance contract standard is on the horizon along with the adoption of IFRS, insurance entities will be bearing the internal costs for the adoption of this Update only to bear further costs for the adoption of the new insurance contract standard and IFRS over a span of 2 to 4 years.

Please find below your original questions with our responses following each of your questions.

## Question 1

The amendments in this proposed Update would revise the definition of an acquisition cost of an insurance entity to be costs that are directly related to the acquisition of new and renewal contracts and include those costs that are (1) incremental direct costs of contract acquisition and (2) directly related to specific activities performed by the insurer for the contract.

- a. Do you agree with this conclusion? If not, what criteria do you think should be used as the basis for capitalization of acquisition-related costs?
- b. Is the proposed guidance operational or is further guidance necessary to implement the proposed guidance?

Insurance contracts are obtained through many different types of distributions. Each insurance entity has a distribution method that is unique to the respective entities' business model. There are a variety of distribution methods including, but not limited to, independent agents, exclusive independent agents, captive agents (agents that are employed by the company), internet sales, television and radio advertising, and direct response advertising. Based on the guidance proposed in the Update, costs directly related to the acquisition of new business with captive agents would no longer be deferred. As noted above, captive agents are insurance agents that are considered employees of the company. The compensation for these agents is a combination of both commissions for the sale of contract, in addition to, salary and benefits. The proposed Update would eliminate the deferral of salaries and benefits since these costs are not considered incremental direct costs. The salaries and benefits are a significant incentive for recruiting and retaining agents in a captive agent distribution. Without these agents, a company would be unable to consistently maintain the agent force needed to distribute insurance products in the marketplace.

Therefore, we do not agree with the conclusion above for two reasons:

1) The fundamentals of GAAP accounting would no longer be precedent because the recognition of expenses and revenues would no longer match. As you know, premium related to life insurance contracts are received and recognized over a period of 15 to 30 years, however, based on the guidance above, the costs related to our captive agency would be expensed as incurred due to the salary and benefit costs not being incremental. Although not authoritative, the Statement of Financial Accounting Concepts No. 5, (CON 5), paragraph 85, states the following regarding expenses:

"Further guidance for recognition of expenses and losses is intended to recognize consumption (using up) of economic benefits or occurrence or discovery of loss of future economic benefits during a period.

Expenses and losses are generally recognized when entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute ongoing major or central operations or when previously recognized assets are expected to provide reduced or no further benefits."

The guidance proposed in the Update would no longer allow insurance entities' with captive agencies to recognize the expenses incurred in the period that the benefits are recognized, i.e., the stream for premium over a 15 to 30 year period. The accounting guidance in the Update will force insurance companies to question whether to use a captive insurance agency model that has historically provided economic benefit. The preferred method of distribution for an insurance entity will be driven by the accounting guidance, as opposed to a method of distribution that has historically been successful.

2) Based on the guidance in the Update, not only would there be inconsistency in the income statement of the recognition of revenues and expenses, but the Update would also create inconsistency between distribution methods that are producing the same product for a company employing multiple distribution systems. As illustrated above, a captive agency force is

compensated through commissions, salaries, and benefits. Independent agencies are compensated largely through commissions only. However, regardless of the type of compensation, the agent is employed to sale insurance products, and all of the costs are incurred for the purpose of the acquisition of insurance contracts, whether it is commissions, salaries, benefits, direct response, agent offices, etc. Based on the guidance in the Update, compensation for selling insurance contracts would be deferred in the independent agency distribution, but not deferred in the captive agency distribution despite the fact that the cost incurred for the captive agency are the same costs incurred for the independent agency. This would further complicate comparability between distribution methods and the insurance industry as a whole.

We are providing an example of the inconsistency this change will create in recognizing acquisition costs between distribution channels within a company. Many captive agencies operate out of company rented offices, the agents are statutory employees and all operating costs are paid by company. The agent employee is generally paid a base salary and receives a commission once sales reach a specified level. All of these costs are now deferred as paid into deferred acquisition costs ("DAC"). In an exclusive agency operation, the agents are independent contractors who pay all of their operating costs out of the commissions they receive. Standard practice is to advance an agent the entire amount of the first year commission when the product is sold. This advance is capitalized as an asset on the balance sheet and recovered as the agent earns the commission. The earned commission is then deferred into the DAC asset. In both cases, the same amount of acquisition cost is paid. The only difference is the classification of that payment.

The proposed guidance creates an inconsistency in accounting for the operating costs of the agency operation. In the captive agency, because these costs are paid directly by the company, they will be expensed immediately while paying these costs as a commission in the exclusive agency system will result in the exact same costs being deferred first as a receivable and then as DAC as that receivable is recovered. Profits from the two books of business will emerge differently even though the ultimate profit recognized on the sale of the policy is the same. Therefore, the proposed guidance in the Update would create an inconsistency within a company, and management and other users of the financial information would lose comparability between two similar distribution methods.

In the illustration below we have illustrated the difference in the emergence of profits using the amended guidance of the Update for deferred acquisition costs for an exclusive agency system and a captive agency system. Under the current practice, the profits are emerging evenly. Using the amended guidance in the Update, the profits do not change for the exclusive agency, but for the captive agency, the first year profits result in a 12.5% loss compared to a 10% gain under the current guidance.

# Proposed Cost Deferral Method - Higher Admin. Expenses in Captive Agency System cannot be Deferred Emergence is Different

	General Agency Distribution System					Captive Agency Distribution System				
Proposed GAAP Reporting	Year 1	Year 2	Year 3	Year 4	Year 5	Year 1	Year 2	Year 3	<u>Year 4</u>	Year 5
Premium Revenue [A]	1,000	683	563	485	427	1,000	683	563	485	427
Investment Income [B]	(61)	(39)	(20)	(8)	2	(45)	(24)	(7)	4	13
Less:										
Policy Benefits & Non Deferred										
Acquisition Expense [C]	520	377	327	293	268	810	377	327	293	268
Amortization of DAC [D]	229	137	109	92	80	180	108	85	72	63
Admin. Expenses & Taxes [E]	90	61	51	44	38	90	61	51	44	38
Profit = [A] + [B] - sum [C] thru [E]	100 10.0%	68 10.0%	56 10.0%	48 10.0%	43 10.0%	(125) -12.5%	113 16.5%	93 16.5%	80 16.5%	71 16.5%

We believe the current guidance in place is sufficient. Although there is diversity in the industry, there is also diversity within the insurance industry regarding the variety of distribution methods. The purpose of deferring acquisition costs is to match the expenses over the period the revenues will be earned. Due to the number of different distribution methods within the industry, it is difficult to amend the current standard in such a way that it will successfully encompass the various distribution methods. We believe the current guidance, though broad, is principles based as written and allows for the diversity of distribution methods within the insurance industry.

The guidance in the Update is operational; however, it will have a significant impact on the industry as noted above. Insurance entities with certain distribution methods will be forced to overhaul the current compensation packages of their entire agent force and consider if the current distribution methods for generating insurance contracts is reasonable considering the proposed guidance. If an insurance entity does not change its current distribution model, it will be left at a competitive disadvantage with its competitors. All of the effort to do this will be followed shortly after with new guidance for insurance contracts and IFRS.

## Question 2

Do you agree that for a cost to meet the definition of a deferred acquisition costs, it must relate to successful efforts (that is, a new or renewal contract)? Please provide the reasons for your view.

No. For an insurance company, deferred acquisition costs are synonymous with the cost of goods sold for a manufacturing company. A manufacturer capitalizes the costs incurred to produce the inventory that will eventually be sold, including raw materials, labor, finished goods, etc. However, based on

consumer demand, all of the products that are produced may or may not end up in the hands of the consumer. Although possible, it would be difficult to determine the percentage of the cost of goods sold that will end in a "successful effort". The same is true in the insurance industry. Insurance companies spend time, money, and effort for the acquisition of a successful contract, however, the acquisition of the contract is not always obtained.

The guidance in the Update proposes that advertising costs incurred by insurance entities should not be included as a part of deferred acquisition costs, but rather, should follow the guidance in Topic 720 or Subtopic 340-20, as applicable. We have no issue with this proposal, as addressed in Question 3 below. One of Torchmark's distribution methods is direct response advertising. However, the guidance provided in the Update for a "successful effort" is not consistent with the guidance for capitalizing costs in Subtopic 340-20. Paragraph 340-20-25-12 states the following:

"Based on the potential customers and the probable customer response rates, direct-response advertising that is expected to produce future revenues generally is undertaken before the customers' identity is known. Such advertising is undertaken with the expectation that not all targets of the direct-response advertising will provide benefits but that the benefits created by the customers who do respond to the advertising will justify the total advertising costs. Accordingly, the cost of the direct-response advertising directed to all prospective customers, not only the cost related to the portion of the potential customers that are expected to respond to the advertising, shall be used to measure the amounts of such reported assets."

As noted above, the costs incurred that can be capitalized for direct response advertising directed to <u>all potential customers</u> is contrary to the proposed guidance in the Update. According to the guidance in paragraph 340-20-25-12, it is expressed that the total cost you have incurred will be recoverable by the "probable customer responses," rather than as the proposed guidance in the Update illustrates that the costs being capitalized are limited to a "successful effort." The concept in accounting for direct response advertising is the same concept as the current concept for deferred acquisition costs. Costs incurred to generate revenue are capitalized and recognized over the period the revenue is earned to the extent those costs are recoverable. The guidance in Subtopic 340-20 alone further illustrates the inconsistency the Update will create between distribution methods, the concept of revenue and expense matching, and other industries whose costs are not capitalized based on a "successful effort".

In addition, based on the current guidance, deferred acquisition costs that are considered unrecoverable from the profits generated by an insurance contract are written off as an expense in the income statement. The same is also true regarding a write-down of inventory in the manufacturing industry. Robust analysis are performed on an annual basis to determine if the profits emerging from a line of business are adequate to recover the deferred acquisition costs related to that line of business. The current guidance prevents an insurance company from deferring excess cost since the deferred costs are limited to the profits of the insurance product. Any costs that are not recoverable are expensed immediately to the income statement. In addition, insurance entities perform "At-Issue" recoverability analysis to determine the appropriate pricing and margin for its products. There are a number of factors that go into pricing, including, but not limited to, a competitive price. If it is determined that the deferred costs will not be recovered "At-Issue", the insurance entity will not have the ability to defer excess costs.

#### Question 3

Do you agree with the amendments in the proposed Update that specify that advertising costs incurred by insurance entities should not be included as part of the deferred acquisition costs but, rather, should follow the guidance for advertising in Topic 720 or Subtopic 340-20, as applicable? Please provide the reasons for your view.

Yes. As noted above, Torchmark has several different distribution methods, including direct response advertising. The current guidance in Subtopic 340-20 is consistent with the current practice for deferring the costs related to the acquisition of business. See additional comments regarding Subtopic 340-20 in our comments related to question 2.

# Question 4:

Do you expect to incur significant costs as a result of the amendments in the proposed Update? If so, please be specific about the nature of the costs you expect to incur.

See our response to Question 2(b). If this Guidance is adopted, companies utilizing captive agencies will be forced to alter their compensation systems keep the same profit flow as a general agency system would produce as illustrated above. The costs incurred related to the accounting and actuarial function would be minimal, however, the costs related to overhaul the current compensation system would require reprogramming of commission systems, updating pricing models, revising commission schedules filed for the each state, and legal compliance costs to name a few. In addition, the disturbance of the agent field will more likely than not, result in high turnover of the agent force. A high level of turnover in the agent field will result in a decline in sales and increased administrative costs for the recruiting and acquisition of new agents.

## Question 5

Do you believe that the proposed effective date is operational?

No. We believe one full year would be needed to adopt the proposed guidance in the Update. One year would allow for the needed time to assess the impact of the guidance, determine the changes that need to be implemented to the current business model, and implement those changes.

If you have any questions, comments or would like further information, please contact us.

Sincerely,

David L. Columbia L.

Danny H. Almond

Vice President & Chief Accounting Officer