# Are you ready for ASU 2010-26 (EITF 09-G)?

*By Rick Farrell, FSA, MAAA*

In October 2010, FASB approved ASU 2010-26 (which was previously known as EITF 09-G while being developed by the Emerging Issues Task Force). This new guidance is intended to address the diversity in practice in the insurance industry related to the determination of acquisition costs which are eligible for deferral. The guidance will be effective for fiscal years beginning on or after December 15, 2011 and is expected to impact nearly every insurer that prepares U.S. GAAP financial statements.

The guidance only allows expenses related to successful acquisitions to be eligible for deferral. This criterion represents a change for most insurers. Until now, companies did not tend to differentiate between new business that eventually was issued versus policies not-taken. With ASU 2010-26, such differentiation is required and could lead to lower amounts being deferred related to expenses for sales and underwriting cost centers. This is especially true for companies which have low placement ratios where there would be a higher proportion of unsuccessful acquisitions. This differentiation will also be a challenge as most companies have not previously captured data on successful/unsuccessful acquisitions and may need to make changes to accounting systems, management information systems, etc. as a result.

The types of expenses that can be deferred are limited to the incremental direct costs related to successful acquisitions. In addition, some payroll-related expenses related to successful acquisitions for underwriting, policy issue, medical/inspection and sales force are eligible as well as certain advertising costs that qualify under direct-response advertising accounting guidance to be capitalized. In the past, some companies deferred expenses related to product development, administrative costs, rent, data processing equipment, training and/or market research. It is

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unlikely that these expenses will be eligible for deferral after ASU 2010-26 is implemented.

The new guidance allows for implementation on either a prospective or retrospective basis. Under retrospective application, companies could be required to reduce amounts previously deferred resulting in lower amounts being amortized in future periods. These lower deferrals may be attributable to expenses related to unsuccessful acquisition efforts and/or eliminating categories of expenses that do not meet the requirements of the new guidance to be eligible for deferral. The main drawback of retrospective application is the effort required to perform the necessary calculations for retrospective application. Even under prospective application, there will be additional effort as there are disclosure requirements to compare capitalized expenses under the prior methodology versus those capitalized in accordance with the new guidance. Note that while the guidance does not provide for a "practical expedient" in retrospective application, a company may make reasonable estimates. Although retrospective application is not required per se, companies may be pressured to do so for competitive and comparative purposes.

Longer term, impacts may include the need for companies to capture and track more data than before (e.g., successful/unsuccessful acquisitions), possible changes to underwriting in order to increase placement ratios (e.g. discontinuing a focus on substandard risks), re-examination of departmental budgets whose expenses are no longer eligible for deferral and higher costs passed on by reinsurers to the extent their deferrals are limited. Administrative and financial reporting systems may not be able to accommodate the increased data requirements without undergoing major changes.

The International Financial Reporting Standards (IFRS) Exposure Draft on Insurance Contracts was released in July 2010. The Financial Accounting Standards Boards (FASB) released its Discussion Paper in September 2010. The convergence of IFRS and U.S. GAAP has been widely discussed and it is conceivable that the Exposure Draft and/or the Discussion Paper could be the standards which will eventually be in place for U.S. GAAP. While a discussion of differences related to the deferral of acquisition costs between the Exposure Draft and ASU 2010-26 is not the intent of this article, suffice it to say that there are differences. Further, since the effective date for the new IFRS requirements will be after the effective date for ASU 2010-26, insurers may need to adjust their deferral practices once upon implementation of the ASU and then later on once the new IFRS/GAAP requirements become effective to the extent they differ from ASU 2010-26.

Companies will need to follow a multi-step process in implementing ASU 2010-26 which includes (1) interpreting how the guidance impacts the company, (2) determining data needs, (3) collecting additional data, (4) evaluating retrospective versus prospective application, (5) updating deferral policy documentation, (6) communicating likely impact to senior management, (7) updating SOX documentation, and (8) modifying DAC models and related data feeds. Several companies are investing efforts to do investigative research so as to understand the implications of the new guidance on their organization. KPMG is well-positioned to assist in such efforts.

# Considerations for insurance companies pursuant to the Dodd-Frank Act

*By David S. Sherwood*

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) was signed into law on July 21, 2010. It may be the most significant piece of reform legislation directed at the financial services industry since the 1930s. Major portions of the industry are targeted for reform, most notably certain types of institutions, such as banks and thrifts and broker-dealers and investment advisers, as well as certain products, including over-the-counter derivatives and the myriad consumer financial products and services.

Insurance companies, as financial services companies, will feel the effects of the legislation directly and also peripherally through the financial activities of their subsidiaries and affiliates. In particular, Title V of the Dodd-Frank Act establishes a Federal Insurance Office (FIO) within the Department of the Treasury that is intended to function in an advisory capacity to the Financial Stability Oversight Council (Council) with regard to systemic risks in the insurance industry (firms and products), to the Secretary of the Treasury with regard to domestic and international insurance issues, and to Congress with regard to modernizing and improving the regulation of insurance companies, including evaluating the effects of federal involvement. Insurance companies may feel the impact of the FIO through its coordination with the states on insurance matters of national and international importance, its systemic risk focus, and through legislation and/or regulation that results from the FIO's recommendations.

Other provisions of the Dodd-Frank Act may also impact insurance companies to the extent they:

- Own an insured depository institution
- Own a non-depository institution financial services subsidiary
- Actively engage in swaps activities
- Are affiliated with a broker-dealer

- Are designated as systemically important
- Are a public company

Although the FIO is not tasked as a federal supervisor or regulator and will primarily serve in an advisory capacity, many within the industry view its creation as a step toward some federal oversight, and perhaps even a federal charter. With that end in mind, the selection of the FIO director, who will shape and shepherd the effort to produce a report in January 2012 on alternatives to modernize and improve regulation of the insurance industry, will likely loom large. Not inconsequentially, the factors associated with federal regulation that are statutorily required to be considered as part of that report clearly direct the FIO to evaluate the benefits of federal involvement in the insurance industry. Critics and advocates seem to generally agree that increased federal involvement is a likely recommendation to be made by the new federal office.

Similarly, although the insurance industry is generally regulated at the state level, there is a growing international influence to insurance supervision. In remarks presented before the London Stock Exchange on November 17, 2010, Deputy Treasury Secretary Neil Wolin stated that the FIO was in the process of becoming a member of the International Association of Insurance Supervisors (IAIS), adding that he anticipates the FIO will be actively involved in working with the representatives of other countries on reinsurance collateral and U.S. equivalence under Solvency II. In collaboration with the Bank for International Settlements' Basel Committee on Banking Supervision (Basel Committee), the IAIS is currently working on reviewing its Insurance Core Principles to address corporate governance issues in the insurance sector. The Basel Committee and the IAIS also intend to collaborate on monitoring the sound implementation of their respective principles. Through the FIO and the Council, these principles will likely be encouraged in the United States. Independently, they will encourage global supervision of insurance companies.

To an outside observer, the insurance industry might appear to have dodged the sweeping effects of the Dodd-Frank Act. Whether because of a misperception about how insurance companies operate or the types of activities in which insurance companies engage through their affiliates, it might seem that the Dodd-Frank Act was directed at "banks" or "Wall Street." In reality, it is not uncommon to find an insurance company with other financial interests, such as a thrift or broker-dealer, which are clearly affected by the provisions of the Dodd-Frank Act. Additionally, the implication of potential federal oversight should not be underestimated.

The ultimate impact of many of these provisions will unfold over the next year or so, as the federal regulatory agencies (including the Council, federal banking regulators, SEC, and CFTC, among others) complete studies and promulgate regulations. For now, it is important for insurance companies to establish a gauge on the scope provisions that will ultimately apply to the operations and organization structure, and set up a clear plan of action where necessary.

# Developments in internal control

*By Seong-min Eom, FSA, MAAA and Ashwini Vaidya, FSA, MAAA*

### Internal control framework

Internal control is *"the integration of the activities, plans, attitudes, policies, and efforts of the people of an organization working together to provide reasonable assurance that the organization will achieve its objectives and mission."*[1] Thus, the main purpose of internal controls should be to provide reasonable assurance that the organization achieves its objectives and mission.

When controls are set up without reference to the organization's objective and mission, they can add to risk and become an impediment by distracting the organization from its purpose and by diverting resources from more productive activities. Before any control is employed, it needs to be rationalized by reference to its purpose and its effectiveness in meeting that purpose. A well-designed control structure aligns the effort in executing the control with the benefit of lowered risk and improved efficiency that it delivers. A lack of robust controls can expose the organization to further risks such as loss of assets or resources, poor or uninformed business decisions, or noncompliance with policies or regulations. On the other hand, excessive controls can lead to increased bureaucracy, reduced productivity, increased complexity, increased cycle time, or increased non-value activities. Rationalized controls consider the organization's structure and operating environment and address the main risks in as efficient a way as possible, with respect to cost and resource commitments. Consequently, rationalizing internal controls mean that for some organizations, certain controls are not feasible because of their size or other reasons.

### Effects of organizational change

Once a well-designed control structure is established and operating effectively, the organization cannot sit back and rely on the initial internal controls. In the current dynamic world, the organization changes, the goals of the organization change, and the processes to meet the goal change. Such changes will naturally require the internal controls to be responsive to changes in order to be effective. The people in the organization should keep alert, and manage the organization attentively.

Controls only provide reasonable comfort, which means that the controls are only as effective as those who administer them, and only as current as the processes of which they are a part. Some limitations are inherent in all internal control systems. Many of the limitations are related to employing the controls ineffectively. Controls can fail when people fail to use them as intended. This aspect of key-person risk can be a large contributor to the risk within an organization.

Examples of key internal controls in practice can help demonstrate how internal controls can help as an organization changes:

- Set documentation standards for the organization: to link individual processes to the objectives and mission of the organization and to establish common practice and organizational norms and values
- Keep a record of decisions: to design more effective processes and coordinate resources
- Make checklists for change management: to assist in making changes systematic

[1] www.osc.state.ny.us/agencies/ictf/docs/intcontrol_stds.pdf

- Test for changes: to ensure that no unintended consequences/changes have occurred; regression testing and attribution analysis can be good tools
- Peer review: to prevent systematic mistakes and to share responsibility

### Extensions to other components of management information

"You get what you measure," and leading organizations are honing their risk adjusted performance measures to reflect what matters—their specific business goals and risk tolerance. Many have moved beyond just SOX-type control metrics over financial reporting. These leading organizations are enhancing their control frameworks so as to measure risk adjusted performance consistently across the organization. They are embedding risk reporting and measurement in each of the business processes within the organization. Risk is defined through a clearly articulated risk appetite with specified risk tolerance. This definition is revisited and updated for emerging risks.

Extensive analysis of these metrics relative to changes in risk drivers is completed and informs adjustments to business goals and strategies. These metrics are published and training and documentation are provided so that they are understood and internalized by the entire organization. The entire organization is involved in the development, measurement, and analysis of these metrics. Every resource is responsible for risk and is evaluated consistently by reference to its risk adjusted performance. All business decisions are evaluated by reference to the risk framework—everything from decisions on pricing and mergers and acquisitions to decisions on supplies, compensation, or recruiting. This embeds the metrics in the organization's regular business process. Integrating these well-understood measures in each of the organization's activities helps the organization's processes, systems, and resources work together to achieve, enhance, and update the organizations goals and strategies.

### Conclusion

As much as internal controls are often maligned, their primary purpose is to help an organization achieve its goals more effectively. Having effective controls in place should not impose constraints on an organization. Internal controls should allow the organization to focus on what is important without having to divert resources to less productive efforts. When controls are not set up effectively, they can lead to an unproductive use of resources.

Internal controls have to be current, adaptable, and relevant. They have to be employed appropriately. They have to be continuously evaluated and cannot be blindly relied on. This can feel like a significant effort, particularly when embroiled in the day-to-day operation of the organization. Having a trusted advisor to help develop a control structure that works for you can be invaluable. KPMG can help evaluate existing processes used in identification, monitoring, and reporting of emerging risks and can help compare the inventory of potential risks against latest industry thinking by tapping into KPMG's industry knowledge base. By identifying strengths and weaknesses in the processes used to prioritize and escalate significant risks, we can help improve an organization's control environment and the effectiveness of its processes.


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  - Internal Audit Services
  - Accounting Advisory Services Support
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  - Global Financial Statement Conversion Services
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  - Project Management Services
- Model Services:
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  - Model Risk and Control
  - Model Validation Services
  - Systems Conversion Support
- Risk and Capital:
  - Risk and Capital Management
  - Transaction Services
- Compliance and Controls:
  - Internal Controls Review
  - Sarbanes-Oxley 404 Compliance Assistance
  - Regulatory Compliance Practice

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