IASB Meeting | Agenda reference **5C**

Staff Paper | Date **April, 2009**

Project **Insurance contracts**

Topic **Acquisition costs**

OBJECTIVE OF THE MEETING

1. The objective of this meeting is to continue deliberations on insurance contracts focusing on the accounting for acquisition costs. At the February 2009 Board meetings, the Boards decided that the initial recognition of an insurance contract should not result in the recognition of a day one gain in earnings or profit and loss. However, both Boards acknowledged that future discussions about the accounting for acquisition costs may necessitate revisiting this decision.

2. At this meeting, the staff will present several alternatives that are applicable under both a fulfilment notion and an exit notion. Because of the Boards' tentative decision not to recognise a day one gain, the issue of acquisition costs is equally relevant to both notions.

ILLUSTRATION OF ISSUES

3. The following illustration highlights the interaction between the measurement of insurance liabilities and the accounting for acquisition costs:

> Insurer A issues Contract A for a single premium of CU100, received at inception, and incurs acquisition costs of CU4. The expected present value of the cash flows is CU90. Insurer A uses brokers and a direct sales force.
>
> Insurer B issues Contract B for a single premium of CU97, received at inception, and incurs acquisition costs of CU1. The expected present value of the cash flows is CU90. The contractual terms, risk profile, and servicing effort are identical to Contract A. Insurer B uses the internet to sell this contract.

Question for the Boards

4. Do contracts A and B have the same fulfilment value at inception? Do Contracts A and B have the same exit value at inception?

Implications for acquisition costs of the answer to that question

5. If contracts A and B have the same measurement at inception, this has the following implications:

   a. the initial measurement excludes the part of the premium from which the insurer recovers the acquisition costs. In this example, the initial measurement of both Contracts A and B would be CU96.

   b. Insurers A and B would recognise the acquisition costs incurred as an expense. There would be no need to even consider capitalising the acquisition costs because that would result in double counting.

   c. Insurer A would recognise income or revenue of CU4 at inception. After the acquisition costs of CU4, there would be no net profit or loss at inception.

   d. Insurer B would recognise income or revenue of CU1 at inception. After the acquisition costs of CU1, there would be no net profit or loss at inception.

6. If contracts A and B have different measurements at inception, this has the following implications:

   a. Insurer A would measure its liability under Contract A initially at (presumably) CU100. Insurer B would measure its identical liability under Contract B initially at CU97.

   b. The boards would need to decide whether insurers should recognise the acquisition costs incurred as an expense or capitalise them.

7. The remainder of this memorandum discusses the follow-on questions, depending on the answer to the question posed in paragraph 4. The staff believes that there is no difference between exit value and fulfilment value when discussing the accounting for acquisition costs. Consequently, the discussion that follows can pertain to a measurement based on exit value or fulfilment value.

8. Paragraphs 14 through 24 discuss the follow-on questions if the answer to the question in paragraph 4 is in the affirmative:

a. In ensuring that no net profit or loss (after acquisition costs) arises at inception, which acquisition costs should be included (incremental, direct, indirect)?

b. What is the presentation in the statement of comprehensive income?

9. Paragraphs 25 through 35 discuss the follow-on questions if the answer to the question in paragraph 4 is in the negative.

a. Should acquisition costs be capitalized or expensed?

b. If acquisition costs are capitalized:

i. How much (essentially the same question as in paragraph 8b)?

ii. What does the asset represent?

10. The issue becomes more complex for insurance contracts that give rise to future premiums (and thus future recoveries of acquisition costs built into those future premiums). However, the staff makes the following observations:

a. Acquisition costs are a significant issue even if there are no future premiums (for example, a single premium contract)

b. Future premiums are a significant issue even if there are no acquisition costs (cross-subsidization between different parts of the portfolio)

c. Nevertheless, future premiums make acquisition costs a significantly greater problem and deferred acquisition costs makes future premiums a significantly greater problem

11. The argument for the view that Contracts A and B should have the same initial measurement is that the two obligations are identical. Furthermore, although the premiums received for the two obligations were different, that difference arose because the policyholder paid for two things: the insurance obligation itself and the acquisition costs. Thus, measuring the insurance obligation at the amount of the total premium paid would not represent faithfully the insurance obligation.

12. The argument for the view that Contracts A and B should have different initial measurements is that the insurer has not yet started to satisfy any of its obligations under the contract. From the policyholder's perspective, it paid a single amount for insurance coverage. The acquisition costs do not relate to a separate deliverable (assuming that if any separate service were provided at inception, the related revenue would be recognised then.)

Staff Recommendation

13. The staff recommends that the measurement of Contracts A and B should be the same at inception. The staff acknowledges the consequences noted in paragraph 5 and notes that the impact to earnings or profit and loss is consistent with the Boards' previous decision not to recognize a day one difference at inception.

STAFF ANALYSIS

If Measurements of Contracts A and B Are the Same

Identification of Acquisition Costs

14. Appendix A provides background information about the identification of, and accounting for, acquisition costs under both US GAAP and IFRS. That appendix also refers to other instances in accounting literature where acquisition-like costs are deferred and amortized.

15. US GAAP and IFRS provide two extremes for identifying acquisition costs. FASB Statement No. 60, *Accounting and Reporting By Insurance Enterprises*, defines acquisition costs as "Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts." Arguably, this can be viewed as a good principle that has been stretched to its limit in practical application. Alternatively, IAS 39, *Financial Instruments: Recognition and Measurement*, limits transaction costs to incremental costs only. If applied in the context of the acquisition of an insurance contract, the incremental costs incurred by an insurer that uses fixed-salary employees may differ significantly from those incurred by an insurer that uses commission-based third party agents. The resulting accounting is contrary to the belief that the measurement of the performance obligation under Contracts A and B are the same.

16. The approach to identifying acquisition costs pursuant to FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, provides an intermediate between Statement 60 and IAS 39. That is, allowing costs that are directly related to the issuance of the insurance contract as well as incremental costs related to the issuance of the insurance contract provides a result that is more consistent with the belief that the measurement of the performance obligation under an insurance contract does not differ between Contracts A and B.

Question for Board

17. In determining that no net profit (after acquisition costs) arises at the inception of an insurance contract, which acquisition costs should be included in that assessment?

Staff Recommendation

18. The staff recommends that acquisition costs be identified as both direct costs and incremental costs of issuing (ie selling, underwriting and initiating) an insurance contract similar to the accounting for loan origination costs in Statement 91.

Presentation of Acquisition Costs

19. Once the acquisition costs have been identified, the presentation of acquisition costs in the statement of comprehensive income must be addressed. There are three potential views:

a. **View A**—Acquisition costs are expensed and revenue is recognized

b. **View B**—Acquisition costs are expensed and income is recognized

View A

20. View A is acquisition costs are expensed and revenue is recognized. Proponents of View A believe that this treatment provides transparency about acquisition costs incurred during the period and reflects the fact the pricing includes "premium loads" to recover these costs.

View B

21. View B is acquisition costs are expensed and a gain is recognized. View B provides transparency about the acquisition costs incurred during the period, as does View A. However, rather than recognizing revenue (as View A does), View B treats the difference between the premium and the initial measurement of the obligation as income. View B avoids the conflict with the preliminary views in the discussion paper on revenue recognition—that is, the revenue cannot be recognized on day one of a contract because performance has not occurred under the contract.

22. Opponents of View B point out that the accounting under this view leads to part of the customer consideration not being recognized as revenue. Said differently, the revenue recognized over the life of the contract does not equate to the premium received; rather the revenue recognized equates to the premium received less the recovery for acquisition costs.

Question for Boards

23. Which view does the Board support?

Staff Recommendation

24. The majority of the staff recommends that acquisition costs are expensed and income is recognized (View B). That is, to the extent that a separate component of the measurement of the insurance contract includes an amount to recover acquisition costs, that amount should be recognized as income to offset acquisition costs.

(The following discussion analyzes the follow-on questions if a decision is reached that the measurement of Contracts A and B are not the same. Many of the arguments discussed below are similar to those discussed above. However, for analysis purposes, the staff has provided recommendations.)

If Measurements of Contracts A and B Are Not the Same

Capitalize or Expense Acquisition Costs

25. Some argue that deferring (and amortizing) acquisition costs reflects the economics of the insurance contract. For example, for long-duration life insurance contracts, the insurance

entity has an expectation that once an insured has been through the underwriting process (questionnaires and medical exams), a predictable number of insureds will continue to renew their insurance contract resulting in the recovery of the acquisition costs incurred by the insurance entity. The future premium payments not only generate future acquisition costs (renewal commissions) but also provide a recovery of those costs. In addition, if an insurance entity were to sell a block of its business, purchase reinsurance, or securitize a portfolio of insurance contracts, that entity would include an amount for the recovery of acquisition costs as part of the price of the block of insurance contracts, charge a ceding commission, or monetize the deferred acquisition costs.

26. Others argue that the deferral of acquisition costs merely reflects an optimistic bias that the business model for insurance (matching of assets and liabilities) will work as intended and represents a self-fulfilling result. They further argue that it is arbitrary to defer acquisition costs just because the compensation structure for the distribution of insurance contracts is front-loaded and that to do so does not reflect the economics. For example, a long-duration life insurance contract is a cost-intensive product initially with the expectation that profits will emerge later in the product life. Depicting that a life insurance contract will recover costs over time ignores the cash flows—that is, initially more cash is paid out (in commissions) to obtain the insurance contract and the expectation is to recover those costs over time. An investor should understand that the life insurance entity is not initially profitable and is relying on estimates of mortality and lapse activity to predict future profitability. Similar to the lesson learned by investors who relied upon highly-rated senior tranches to guide their investing (especially in collateralized debt obligations comprised of equity tranches of collateralized debt obligations), relying on historical information to predict the future has risk and paying substantial commissions in the first year of an insurance contract contains risk as well. Furthermore, not capitalizing acquisition costs, together with not recognising any day one revenue, is consistent with the conclusions reached in the discussion paper on revenue recognition—that is, acquisition costs are expensed and revenue is only recognized when the entity has performed under the contract.

Question for the Boards

27. Should acquisition costs be expensed at inception or deferred and amortized in a subsequent period?

Staff Recommendation

28. The staff recommends that acquisition costs be capitalized. If the Boards agree with the staff recommendation, the subsequent amortization of the capitalized acquisition costs will be discussed at a future meeting.

(If a decision is reached that acquisition costs should be deferred, the following section is relevant.)

How much of the acquisition costs should be recognized?

29. The staff believes that the discussion in paragraphs 14 through 18 about the identification of acquisition costs is relevant to determining how much of the acquisition costs should be recognized and should be referred to in analyzing this issue.

Question for Boards

30. How much of the acquisition costs should be recognized?

Staff Recommendation

31. Consistent with its recommendation for the identification of acquisition costs, the staff recommends that acquisition costs be identified as both direct costs and incremental costs of issuing an insurance contract.

Capitalized Asset

32. The deferral of expenses has always been difficult to support as a standalone asset. Those deferred expenses do not meeting the definition of an asset within the Conceptual Framework. As a result, some have argued that deferred acquisition costs represent a customer intangible (similar to a core deposit intangible in the banking industry which represents the long-term relationship with depositors). They believe it is difficult to argue against the assertion that some type of customer intangible exists (or has been obtained) when an insurance contract is issued especially in instances where the measurement of the insurance contract provides for recovery of acquisition costs.

33. Others point out that, as noted in the discussion paper for insurance contracts, in most instances the acquisition costs do not reflect the customer intangible and most definitely does

not reflect that customer relationship in subsequent periods. They believe that using acquisition costs as a proxy for the customer intangible is misleading. In addition, the idea of a customer intangible for a single premium contract is difficult to support. For example, a case can be made for an insurance contract with annual premiums that the acquisition process continues every time a premium is received and, therefore, an asset can be supported. However, for a single premium insurance contract, the acquisition process ends when the single premium is received.

Question for Boards

34. What does the asset represent?

Staff Recommendation

35. The staff recommends that the asset be depicted as a customer intangible.

Appendix A

A1. The following appendix provides background information about acquisition costs.

What are acquisition costs?

A2. IFRS and U.S. GAAP are consistent with regard to guidance on acquisitions costs—that is, both accounting regimes are vague and subject to significant judgment. IFRS 4, *Insurance Contracts* is an interim standard. Accordingly, IFRS 4 did not address the accounting for acquisition costs because in some cases those costs were an integral part of existing models and would require a fundamental review of the model. Under U.S. GAAP, FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*, paragraph 28, provides the following description:

> Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred shall be considered acquisition costs.

A3. The accounting policies of insurers for acquisition costs have varied in the past. Specifically, the "other costs" have included a percentage of the salaries of the underwriting personnel to a percentage of the rent related to the space occupied by underwriting personnel. In some instances, a percentage of the entity's executive compensation (for example, the chief executive officer and the chief financial officer) is included as acquisition costs to be deferred and amortized over time.

A4. The Discussion Paper, *Preliminary Views on Insurance Contracts* (DP), stated that one view is that the insurer should recognize an intangible asset to reflect the initial investment made to acquire the customer relationship. Proponents of this view believe that deferring acquisition costs results in an appropriate cost-based measurement of the investment. The IASB's preliminary view was that recognizing a separate intangible asset (measured at the amount of acquisition costs incurred) and at the same time recognising an insurance liability (measured at the amount of the premium received) overstates the insurance liability. In addition, the IASB observed that the asset represents either an asset that does not

exist (if acquisition costs are recovered through cash received) or relates to future cash flows that are included in the measurement of the insurance liability. Accordingly, the IASB concluded that acquisition costs should be expensed and at the same time income should be recognized. The income represents the recovery of the acquisition costs from cash already received or from the present value of future premium receipts qualifying for inclusion in the measurement of the insurance liability (using the guaranteed insurability test). [We note that under the DP proposal, income would not be limited to the amount that would recover the related acquisition costs, that is, a net day one gain would be possible.]

A5. The discussion paper also provided examples of a single premium and regular premium (instalment) contracts. The IASB observed that a separate measurement of the customer intangible does not equal the acquisition costs. Further, the subsequent amortization of the deferred acquisition costs would not represent a good proxy of the customer relationship.

Comments from Respondents to the Discussion Paper

A6. Respondents' comments about acquisition costs varied based on the type of insurance contract. For example, respondents (life, long-duration) generally agreed that acquisition costs should be expensed when incurred if the measurement of the insurance liability reflects all future cash flows from which the acquisition costs are recovered. Some respondents (life, long-duration, mutual) observed that the accounting for acquisition costs related to long-duration contracts is especially complex and burdensome (specifically retrospective adjustments and internal replacements) and, as a result, should be simplified.

A7. On the other hand, some respondents (non-life, short-duration) supported recognizing acquisition costs as an intangible asset. That intangible asset would be amortised in line with the recognition of premium revenue. These respondents supported an unearned premium approach for the pre-claims period of non-life insurance contracts.

Is the deferral of acquisition costs unique to insurance contracts?

A8. The deferral of acquisition costs is most prominent in the accounting for insurance contracts. However, other instances exist where costs are deferred and amortized over time. Both IFRS (IAS 39, *Financial Instruments: Recognition and Measurement*, and IAS 18, *Revenue*) and US GAAP (FASB Statement No. 91, *Accounting for Nonrefundable Fees and*

Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases) result in deferral of costs through the use of the effective interest method.

A9. IAS 39 includes *transaction costs* within the calculation of effective interest for (a) loans and receivables and (b) debt securities classified as held-to-maturity. *Transaction costs* are defined as "incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument." Paragraphs 6 and 7 of Statement 91 include direct loan origination costs within the calculation of the interest method and are described as follows:

> Direct loan origination costs of a completed loan shall include only (a) incremental direct costs of loan origination incurred in transactions with independent third parties for that loan and (b) certain costs directly related to specified activities performed by the lender for that loan. Those activities are: evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating loan terms; preparing and processing loan documents; and closing the transaction. The costs directly related to those activities shall include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan.
>
> All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

A10. Statement 91 defines *incremental direct costs* as:

> Costs to originate a loan that (a) result directly from and are essential to the lending transaction and (b) would not have been incurred by the lender had that lending transaction not occurred.

A11. While both IAS 39 and Statement 91 require deferral of acquisition costs, the costs eligible for deferral are more limited in nature because of the reference to "incremental costs." The definition of acquisition costs deferred related to insurance contracts is much broader and has been applied even more broadly. Other examples of deferring acquisition costs exist in US GAAP and are included in the next paragraph.

Other Existing Guidance That Includes Deferral of Acquisition-Like Costs

A12. Two observations about these additional examples where acquisition-like costs are deferred are that these examples (a) pertain to specific industry guidance and (b) in many cases were carry-forwards of existing literature with little deliberation (similar to Statement 60) at a time when the matching principle was prevalent and accepted in accounting. Some of these instances include:

a. FASB Statement No. 19, *Financial Accounting and Reporting by Oil and Gas Producing Companies*, requires numerous costs (not just costs related to fixed assets) can be deferred including costs related to exploration, development, and production

b. FASB Statement No. 50, *Financial Reporting in the Record and Music Industry*, requires that the portion of the cost of a record master borne by the record company shall be reported as an asset if the past performance and current popularity of the artist provides a sound basis for estimating that the cost will be recovered from future sales.

c. FASB Statement No. 51, *Financial Reporting by Cable Television Companies*, requires that initial subscriber installation costs, including material, labor, and overhead costs of the drop, be capitalized. Statement 51 also requires that initial hookup revenue shall be recognized as revenue to the extent of direct selling costs incurred.

d. FASB Statement No. 63, *Financial Reporting by Broadcasters*, requires the recognition of an asset for costs (the rights acquired) related to a license agreement for program material

e. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, requires, under certain conditions, the capitalization of preacquisition costs, project costs, costs to sell real estate projects, and costs incurred to rent real estate projects.

f. FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*, requires that costs of producing product masters incurred subsequent to establishing technological feasibility shall be

capitalized. Those costs include coding and testing performed subsequent to establishing technological feasibility. Software production costs for computer software that is to be used as an integral part of a product or process shall not be capitalized until both (a) technological feasibility has been established for the software and (b) all research and development activities for the other components of the product or process have been completed.

g. FASB Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, requires that costs that are directly related to the acquisition of a contract and that would have not been incurred but for the acquisition of that contract (incremental direct acquisition costs) should be deferred and charged to expense in proportion to the revenue recognized. All other costs, such as costs of services performed under the contract, general and administrative expenses, advertising expenses, and costs associated with the negotiation of a contract that is not consummated, should be charged to expense as incurred.

A13. The appendix to IAS 18 *Revenue* contains guidance on the treatment of investment management fees and related acquisition costs (though it does not use that term) That precedent is relevant to many insurers for non-insurance products they provide, such as mutual funds and some types of investment contract. That guidance is:

Investment management fees.

Fees charged for managing investments are recognised as revenue as the services are provided.

Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. As in IAS 39, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment management services, and is amortised as the entity recognises the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis.

Some financial services contracts involve both the origination of one or more financial instruments and the provision of investment management services. An example is a long-term monthly saving contract linked to the management

of a pool of equity securities. The provider of the contract distinguishes the transaction costs relating to the origination of the financial instrument from the costs of securing the right to provide investment management services.