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Project	**Insurance contracts**
Topic	**Acquisition costs - recoverability**

Purpose of this paper

1. This paper discusses the possible recoverability of acquisition costs in the event of a policyholder lapsing. The amounts recoverable can come from lapse penalties or early termination charges paid by the policyholder or from the agent.

2. The paper also provides, in an appendix, some background material that may help the boards attempt to reconcile their different views related to acquisition costs.

Staff recommendation

3. The staff recommends the FASB to acknowledge a right to claw back lapse penalties and early termination charges borne by a third party (e.g. an agent) as an asset. This asset is measured as the commission charged at inception (the prepayment to the contract) and is subject to amortisation according to the clawback schedule.

4. The recommendations in this paper are solely for the FASB. The recognition of the separate asset discussed in paragraph 3 would be inconsistent with the approach adopted by the IASB, because it would result in double counting.

Under the IASB's approach, the expected present value of lapse and surrender charges, whether borne by the agent or by the policyholder, is included in the measurement of the insurance contract.

Previous decisions

5. The boards decided tentatively that acquisition costs shall be expensed as incurred. The IASB decided tentatively to exclude from the initial measurement of the residual margin an amount equal to the incremental acquisition costs. The IASB did not decide any further whether that tentative decision would be best reflected by:

   (a) excluding the acquisition costs from the premium to which the contract liability is calibrated; or [the recent staff draft circulated to the boards takes this approach]

   (b) including the acquisition costs in the contract cash flows at the inception of the contract.

6. The FASB decided tentatively not to recognise any corresponding amount of the premium as revenue (or income) at inception.

7. The boards noted that some acquisition costs or some level of the acquisition costs incurred may be recoverable, in the event of policyholder lapse, either from the policyholder or from third parties. The circumstances of such "recoverability" are set out in this paper. The staff thinks that understanding those circumstances might help the boards to arrive at a common answer for the treatment of acquisition costs.

Background

8. Insurance contracts often contain lapse penalties and/or early termination penalties to recover acquisition costs. This is particularly true for long-term insurance contracts for which insurers incur significant acquisition costs. By

setting penalty charges for lapses and early termination, the insurer recovers all or parts of its acquisition costs from the policyholder.

9. In some cases, an insurer has a recapture agreement with agents. Such agreements stipulate that, in the event of lapse, the agent may have to repay some or all of the initial commission paid by the insurer, usually on the basis of a pre-determined scheme. The idea behind a recapture agreement is to push some of the persistency risk onto the agent, especially in very high-value contracts. The recapture agreement may also give the agent an incentive to nurture the relationship with the customer to reduce the risk of lapse.

Are recoverable acquisition costs an asset?

10. In order to gain a better understanding of what it means that some acquisition costs may be recovered, the staff analyses whether a right to recover acquisition costs on lapse meet the definition of an asset and should be recognised as such.

11. The IASB's *Framework* (paragraph 49 (a)) defines an asset as

> a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

12. The FASB's Statement of Financial Accounting Concepts No. 6 *Elements of Financial Statements* defines assets similarly as

> probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.

13. Another example is IAS 32 *Financial Instruments: Presentation* (paragraph 11) and *FASB Accounting Standards Codification*™ Paragraph 825-10-15 of Topic 825, Financial Instruments, that describe a financial asset as an asset that is cash, an equity instrument (from another entity or the entity's own equity) or a contractual right to receive cash or exchange financial assets or liabilities under conditions that are potentially favourable. This description stresses the importance of a contractual right that a financial asset needs to incorporate.

14. The simple occurrence of expenditure may be an indication of the generation of an asset, although it is not sufficient to meet the definition of an asset. In the case of a right to recover acquisition costs on lapse, the control over that right is the crucial point. The occurrence of lapse penalties or early termination charges is not certain and the insurer has no control over the policyholder lapsing or continuing the contract. Overall, the insurer may recover the acquisition costs, but it has no control over how this will happen.

15. The staff analyses whether a right to recover acquisition costs on lapse can qualify as an asset. This can be considered by looking at the "alternatives" how acquisition costs may be recovered:

    (a) from the agent or

    (b) from the policyholder.

Recover acquisition costs from the agent if the policyholder cancels the insurance contract

16. Suppose the contract between the insurer and the agent specifies that the agent must repay part of its commission to the insurer if the insurance contract lapses within 5 years. The agent has a stand-ready obligation (a liability) to repay part of the commission if lapse occurs within that period. Although the ultimate outcome of that obligation is conditional on lapse, the obligation itself is unconditional. If the agent has an unconditional obligation (liability) towards the insurer, the insurer has a corresponding unconditional right against the agent. Although the ultimate outcome of that right is conditional, the right itself is unconditional. The uncertainty of the outcome does not impact the recognition of this asset, but does affect its measurement.

Recover acquisition costs from the policyholder

17. The recoverability of acquisition costs from the policyholder is, apart from the reimbursement from the agent, the standard case. The insurer (presumably) expects to recover acquisition costs over the course of the contract if the contract continues for its full term. The insurer can protect its position by including

lapse penalties or early termination charges in the contract clauses. This would mean that either way – through the life of the contract or by means of charges if the policyholders cancels the contract - the insurer will recover the acquisition costs.

18. Suppose the insurance contract requires the policyholder to pay a surrender charge (by deduction from the surrender proceeds) if it cancels the contract. The policyholder can avoid that charge by not cancelling the contract. Therefore, the policyholder has no stand-ready obligation to pay the charge and so has no liability. As a result, the staff concludes that no separate asset arises for the insurer from the contractual term permitting the insurer to levy a surrender charge.

Measurement of the asset

19. The staff considered two approaches to the measurement of the insurer's right to claw back commission from the agent:

    (a) On a probability-weighted basis.

    (b) As a pre-payment of a service provided by the agent over time.

20. A probability-weighted measurement would be consistent with the treatment of lapses in measuring the underlying insurance contract. However, in previous discussions, FASB members have indicated that they view acquisition costs as arising from a separate contract unrelated to the insurance contract. From that perspective, consistency with the measurement of the insurance contract seems unnecessary.

21. A probability-weighted measurement would also be consistent with the treatment of rights of return in the draft exposure draft on revenue recognition. In effect, the policyholder has a right to "return" an unwanted contract. However, commission clawbacks are often structured as a sliding scale, designed to give the agent an incentive to nurture the customer relationship and so minimise lapses. That seems more consistent with viewing the commission as a continuing service provided by the agent over the clawback period.

22. Accordingly, the staff recommends that the commission paid should be treated simply as a prepayment, to be amortised in accordance with the clawback schedule.

Question for the boards
Do you agree with the staff recommendation in paragraphs 16, 18 and 22 to acknowledge, under the FASB model on acquisition costs, an asset for acquisition costs recoverable from a third party? This asset shall be initially measured at the commission paid and should be in accordance with the clawback schedule.

Appendix: Consequences for the overall model

A1. The boards will in a separate discussion at this meeting attempt to resolve differences between their tentative decisions. This appendix is designed to provide some additional input for that discussion, in the light of the material in the body of this paper.

A2. The approach adopted by the IASB:

(a) applies the same treatment (probability-weighted basis) to **all cash flows** from which an insurer may recover its acquisition costs, either by generating cash inflows from the policyholder from the ongoing contract or by early termination or lapse charges against the policyholder or the agent. This captures any interdependencies between those cash flows and other cash flows arising from the insurance contract.

(b) in determining the amounts of its expected (probability-weighted) cash flows to measure the insurance contracts, considers in the scenario analyses all relevant factors, such as contractual terms, its own experience and market practices.

(c) excludes the incremental acquisition costs from the initial measurement of the residual margin. Therefore, recovery through surrender charges or from margins through the life of the contract would, in effect, result in a smaller residual margin at inception.

A3. The basis underlying the approach adopted by the FASB is that acquisition costs are costs of sale and completely independent of the contract itself. As a result, the FASB's approach on acquisition cost (as supplemented by the recommendations in the body of this paper) applies different approaches to recoveries of acquisition costs depending on their source:

(a) If recovery is from **the agent**, the right to the recovery would be treated as a separate asset, namely a prepayment of a service provided over the clawback period (on a 100% basis, not a probability-weighted basis).

(b) Recovery through **surrender charges or from margins through the life of the contract** would not be recognised as a separate asset but would be included, on a probability-weighted cash flow basis (consistent with the IASB's approach in paragraphs A2 (a) and (b)) in the measurement. But because the FASB does not exclude any acquisition costs from the initial measurement of the composite margin, the recovery of the acquisition costs, in effect, results in a bigger composite margin at inception and is released over time.