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Project **Insurance contracts**

Topic **Acquisition costs**

Purpose of this paper

1. At the July Joint Board meeting, staff will ask the boards to conclude on the accounting for acquisition costs arising from insurance contracts.

2. The Boards reached different tentative decisions about the accounting for acquisition costs:

   (a) The IASB has tentatively decided that an insurer should:

      (i) expense acquisition costs when incurred

      (ii) at inception, recognise as revenue the part of the premium that covers acquisition costs. For this purpose, acquisition costs should be limited to the incremental costs of issuing (that is, selling, underwriting and initiating) an insurance contract and should not include other direct costs. Incremental costs are those costs that the insurer would not have incurred if it had not issued those contracts.

   (b) The FASB has tentatively decided that an insurer should:

      (i) expense all acquisition costs when incurred

      (ii) not recognize any revenue (or income) at inception to offset those costs incurred.

3. The staff is seeking to develop a common view between the Boards about the accounting for acquisition costs. However, if a common view cannot be reached

at this meeting, the staff intends to proceed with deliberations. Once deliberations are completed, the staff will present to the Board all differences that may arise in the course of those deliberations. At that time, if the Boards are unable to agree on a common view, the exposure draft will include both Boards' conclusions where those conclusions differ.

Summary of staff recommendations

4. This paper argues that:

   (a) If the Boards' primary objective is to measure the remaining obligation arising from the insurance contract, then the Boards should support recognizing as revenue the part of the premium that covers acquisition costs (IASB tentative conclusion)

   (b) If the Boards' primary objective is consistency with the preliminary views in the revenue recognition project, then the Boards should support not recognizing any revenue or income at inception to cover acquisition costs (FASB tentative conclusion).

5. Staff did not reach a conclusive recommendation on which of these two positions should prevail.

6. If the Boards decide that an insurer should recognise revenue at inception to cover acquisition costs, the staff recommend that the revenue recognised at inception should equal the incremental costs (thus excluding other direct costs that are not incremental at the contract level).

Structure of the paper

7. The rest of this paper is divided into the following sections:

   (a) What are the bases for the decisions reached by each Board?

   (b) What feedback have we received from constituents?

   (c) What precedent(s) may be set for recognizing revenue at the same time as acquisition costs?

   (d) If the Boards decide that revenue should be recognized at the same time as acquisition costs, how should an insurer determine which part of the premium covers acquisition costs?

What are the bases for the decisions reached by each Board?

8. Both the IASB and FASB tentatively decided that acquisition costs should be expensed rather than deferred. However, the IASB tentatively decided that revenue should be recognized at the same time as incremental acquisition costs whereas the FASB did not support revenue recognition for acquisition costs.

IASB basis for tentative decision

9. The IASB supported recognizing revenue at the same time as acquisition costs based on the view that part of the premium received is compensation for acquisition costs, not compensation for the insurance obligation itself. The measurement at inception should not be different for two insurance obligations that have identical contractual terms and risk profile and require identical servicing effort, but differ in price solely because the insurer incurred different acquisition costs and priced the contract to recover those costs. (Consequently, those differences arise because the policyholder paid for (at least) two things: the insurance obligation itself and the acquisition costs.) Thus, measuring the insurance contracts initially at the amount of the total premium received would not represent faithfully the remaining obligations.

FASB basis for tentative decision

10. The FASB supported not recognizing revenue at the same time as acquisition costs because the insurer should recognize revenue only when it satisfies its performance obligations under the insurance contract. At inception, the insurer arguably has not satisfied any of its obligations under the contract, so no revenue (or income) is recognized. The FASB pointed out that it would be consistent with the conclusions reached in the discussion paper on revenue recognition (and would be consistent with how acquisition costs are accounted for across most other industries). In addition, the FASB observed that in many instances the pricing function for an insurance contract does not separately identify a portion of the premium for the recovery of acquisition costs. Accordingly, using the acquisition costs as a proxy for that amount to recognize revenue at inception may lack reliability.

11. The bases described in paragraphs 7 and 8 can be summarised into the following two positions:

    (a) If the Boards' primary objective is to measure the remaining obligation arising from the insurance contract, then the Boards should support recognizing as revenue the part of the premium that covers acquisition costs (IASB tentative conclusion)

    (b) If the Boards' primary objective is consistency with the preliminary views in the revenue recognition project, then the Boards should support not recognizing any revenue or income at inception to cover acquisition costs (FASB tentative conclusion).

12. Staff did not reach a conclusive recommendation on which of these two positions should prevail.

What feedback has been received by constituents?

13. The Insurance Working Group met on June 29 and 30. One of the topics that the staff sought input on was the accounting for acquisition costs. In addition, the staff received several unsolicited comment letters from interested constituents (preparers and users) about the tentative decisions reached by each Board. The majority of the comments focused on the negative impact to insurance entities/products, particularly for life insurance, if revenue is not recognized at the same time as acquisition costs. These constituents asserted that not recognizing revenue in these instances leads to:

    (a) Information that is not decision-useful because it reports a loss at the inception of contracts that are expected to be profitable over the entire lifetime of the contract

    (b) The need for disclosure of embedded value information or other supplementary information to compensate for the effects of financial reporting that is not informative (in other words, compensating for the effect described under (a))

    (c) The loss of key analytical data about past investment in contracts (for example, the amount of acquisition costs)

14. Some constituents suggested alternatives to expensing such as deferring and amortizing acquisition costs over the duration of the contract as the insurer provides risk protection to the insured. Alternatively, some suggested that the deferred acquisition costs could be viewed as an intangible asset (for example, a customer relationship asset) that is amortized in a similar manner. [Staff does not discuss these alternatives in this paper because the purpose of this paper is to seek a common view between the Boards about acquisition costs based on the Boards' tentative decisions described in paragraphs 9 and 10].

What precedent(s) may be set for recognizing revenue at the same time as acquisition costs?

15. One of the key considerations for this project is the precedent set by decisions reached. Because this project has a focus on a particular type of transaction, care must be taken to align the accounting for these contracts with accounting for other similar items wherever feasible and not create specialized guidance unless there are compelling reasons to do so. Insurance contracts, particularly many longer duration contracts, are often distributed through channels that create more significant acquisition costs than those that arise for many revenue transactions in other industries, though material acquisition costs sometimes arise in other industries. Material acquisition costs are more likely to be large for insurance contracts than for many other types of revenue transaction and many insurance contracts last for many years, but the staff are not aware of any reason to consider treating insurance contracts differently from other revenue transactions. In addition, historically the identification of acquisition costs has been subject to significant judgment.

16. The staff has identified some other instances where acquisition-like costs are deferred and may be impacted by a decision in the insurance contracts project to recognize revenue at the same time as acquisition costs. Some of those instances are:

    (a) IAS 18, *Revenue*, and 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 contract origination costs.

(b) 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

(c) FASB Statement No. 45, *Accounting for Franchise Fee Revenue*, requires that revenue be recognized when all material services and conditions relating to the sale have been substantially performed or satisfied by the franchisor. Statement 45 also requires that direct costs relating to franchise sales for which revenue has not been recognized ordinarily shall be deferred until the related revenue is recognized.

(d) 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.

(e) 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.

(f) 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

(g) 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.

(h) 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.

(i) 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.

(If the Boards agree that revenue should be recognized at the same time as acquisition costs, the following discussion is necessary.)

How should an insurer determine which part of the premium covers acquisition costs?

17. US GAAP and IFRS provide two extremes for identifying acquisition costs.

(a) FASB Statement No. 60, *Accounting and Reporting By Insurance Enterprises*, defines acquisition costs as "…those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts."

(b) IAS 39, *Financial Instruments: Recognition and Measurement*, and IAS 18, *Revenue*, limit the deferral of transaction costs (or origination costs) to incremental costs only - those costs that the insurer would not have incurred if it had not issued the particular contract.

18. 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 approach between those in Statement 60 and IAS 39. That approach, in the context of an insurance contract, may include all costs that are directly related to the issuance of the insurance contract, not just the incremental costs.

19. From the April 2009 paper on acquisition costs, staff identified the following two approaches:

    (a) Acquisition costs should be defined as the incremental costs of issuing an insurance contract. This approach is consistent with how IAS 39 determines transaction costs (see paragraph 17(b)) and arguably provides a principle that is less complex and less arbitrary than any other definition for acquisition costs.

    (b) Acquisition costs are those 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. Some may argue that the principle of incremental acquisition costs is too narrow to adequately reflect the various sales structures that can occur for insurers; it may result in different answers for sales structures that have the same cost level but use different channels (for example, external agents versus direct writing).

20. As mentioned earlier, the IASB has decided tentatively that, for the purpose of recognising revenue at inception, acquisition costs should be defined as the incremental costs of issuing an insurance contract. Staff notes that:

    (a) Staff still believes that defining acquisition costs as direct costs of issuing an insurance contract, rather than limiting them to incremental costs, is more consistent with the principle of measuring the remaining obligation.

    (b) On the other hand, staff has not identified any additional arguments for deciding between the two approaches in paragraph 19 since the April discussion.

21. As a result, staff recommends that the revenue recognised at inception should be equal to the incremental costs.

Questions for the boards
1. Paragraph 11 describes two positions: (a) The Boards' primary objective is to measure the remaining obligation arising from the insurance contract. Therefore, an insurer should recognise as revenue at inception the part of the premium that covers acquisition costs. (b) The Boards' primary objective is consistency with the preliminary views in the revenue recognition project. Therefore, an insurer should not recognise any revenue (or other income) at inception to cover acquisition costs. Which of these two positions do you prefer? 2. If you prefer an approach that recognises revenue at inception to cover acquisition costs, do you agree with staff recommendation in paragraph 21 that the revenue recognised at inception should be equal to the incremental costs.