Contact(s)	**Hans van der Veen**	hvanderveen@iasb.org	+44 (0)20 7246 6464
	Mark Trench	metrench@fasb.org	+1 (0) 203 956 3455
	Jeffrey Cropsey	jdcropsey@fasb.org	+1 (0) 203 956 5305

Project **Insurance contracts**

Topic **Acquisition costs**

Purpose of this paper

1. This paper deals with the treatment of acquisition costs, defined in this project as incremental costs directly related to the successful acquisition of an insurance contract.

2. This paper assumes that the Boards have accepted the notion that incremental acquisition costs (and their recovery) are a part of the contract cash flows (broad rather than narrow—see agenda paper 1A/FASB memo 51A on cash flows arising in fulfilling a contract). However, even if the broad cash flow premise is not accepted, the fact still remains that the insurance contract generally is priced to recover acquisition costs—through future premiums and surrender charges. Those costs are the subject of this paper.

3. The paper also provides, in Appendix A, some background material brought forward from the June joint board meeting AP 2F/FASB 50F that may help the boards attempt to reconcile their different views related to acquisition costs.

Staff recommendation

4. The boards have tentatively decided that an insurer should recognise acquisition costs as an expense when incurred, and this paper proposes no change to that decision.

5. In addition, the majority of the staff support the following approach: reduce the residual or composite margin at initial recognition (but not below zero) by the amount of incremental acquisition costs incurred. The insurer would achieve this either (a) by excluding that amount from the initial measurement of the margin (the approach taken in the recent staff draft) or (b) by including that amount in the cash outflows. As a result, the insurer would recognise that amount as revenue at inception.

6. Some staff recommend the boards consider recognizing the right to recover incremental acquisition costs as a recoverable asset—ie recognized as an asset recoverable through the various sources of cash flows described in paragraph 7(b) and amortized over the period of receipt of those cash flows.

Approaches discussed in this paper

7. This paper discusses possible approaches to accounting for acquisition costs, based principally on two notions:

   (a) That acquisition costs (at inception and renewal) are part of the contract cash flows

   (b) That acquisition costs (whether or not part of the contract cash flows) would typically be fully or partly recoverable because:

      (i) the amount of the acquisition cost is included in the pricing of the contract and therefore recoverable from the premiums, and

      (ii) if a policy should lapse, remaining amounts are recoverable from lapse penalties or early termination charges withheld from the policyholder at contract surrender or termination.

8. The boards have decided tentatively that acquisition costs will be expensed as incurred.

9. An insurer could account for the recovery of incremental contract acquisition costs in one of the following ways:

   (a) Reduce the residual or composite margin at initial recognition (but not below zero) by the amount of incremental acquisition costs incurred. The insurer would achieve this either (i) by excluding that amount from the initial measurement of the margin (the approach taken in the recent staff draft) or (ii) by including that amount in the cash outflows. As a result, the insurer would recognise that amount as revenue at inception. The IASB has tentatively adopted this approach.

   (b) Recognize a separate asset recoverable through the various sources of cash flows described in paragraph 7(b) and amortize that asset over the estimated life (timing and amount) of those cash flows.

   (c) Recognize no revenue at inception of the insurance contract. The FASB has tentatively adopted this approach.

10. Three other sources of possible recovery of acquisition costs have been brought to the staff's attention. Because of the facts noted below surrounding these possible sources, none will be discussed further in this paper:

   (a) Some have noted insurers may sometimes be willing to incur acquisition costs at least partly in the expectation that persuading the policyholder to enter into a contract may generate a customer relationship that will generate future profitable contracts. The staff have not pursued that notion because such assets are not generally recognized outside a business combination. Although many would agree that an insurance contract is likely accompanied by an intangible asset related to future contracts, the measurement issues seem to outweigh the benefits at this time. However, it should be noted that the life insurance actuaries calculate a value of business acquired (VOBA) (eg, for business combinations) which can include both the value of the business in force as well as the value of future related business. Because of the apparent lack of board support, this notion will not be pursued any further.

(b) The claw-back of agent's commissions could provide for recovery of at least some of the initial insurance contract commission if the contract terminates early. Depending on the contract between the insurer and agent, some of the commissions for those early terminations may not be considered fully earned by the agent and therefore clawed-back (due back) to the insurer. Likely any return commission due would be smaller as the insurance contract matures. This potential source of recovery also may or may not be included in the contract cash flows depending on the interpretation of cash flows taken. In any case measurement of such recovery would include impairment (because of the possibility of default by the agent). Although these agent claw-backs may be considered in the contract cash flows, they seem unlikely to provide a significant source of recovery of acquisition costs.

(c) If the acquisition costs are related to a contract that is proportionally reinsured, the proportion of the acquisition costs related to the reinsurance contract likely will be recovered through a ceding commission. However, the reinsurance contract would not under any situation discussed by the boards be part of the contract cash flows—but rather accounted for as a separate contract. Also the reinsurer's portion of the related premiums and surrender charges would be payable to the reinsurer. Another way of looking at ceding commission is as follows: the policyholder pays for the whole of the underlying acquisition costs, and the ceding commission is simply a mechanism for the cedant to retain the portion of the premium from the underlying contract that pays for the acquisition costs, while passing on to the reinsurer the portion of the premium that relates to the risks transferred to the reinsurer.

Analysis

11. The IASB has tentatively decided to expense acquisition costs at inception and offset that amount by an equal amount of premium. The premise is that the cash flows (premiums and lapse penalties) included enough premium in the contract pricing to offset the acquisition costs and that the initial measurement of the contract should reflect that fact. (If the contract pricing is insufficient to recover all the acquisition costs, this fact will be captured by the requirement that the residual / composite margin cannot be negative. Moreover, in those circumstances, the revenue recognised at inception will be the portion of the acquisition costs that is recoverable.)

12. The FASB tentatively decided to expense acquisition costs with no premium offset on the basis that the acquisition costs were incurred as the result of a third party contract not related to the insurance contract.

13. The majority of the staff recommends the boards require insurers to recognise all acquisition costs (incremental and non-incremental) as an expense and offset those expenses by recognising at that point revenue equal to the portion of the incremental acquisition costs that is recoverable from any source, ie clawback from agents, surrender charges from the policyholder or contract margins (reducing the residual/composite margin at inception, but not below zero). Those staff believe that including in the same measurement all cash flows from which the insurer expects to recover incremental acquisition costs:

    (a) involves no loss of information for users.

    (b) is simpler than reporting some of those cash flows as arising from a separate asset (eg for those recoverable from agents) and others within the overall measurement of the contract.

14. However, recognising a gain at the initial recognition of an insurance contract assumes that the cash flows from premiums over the life of the contract and surrender and termination charges are sufficient to recover the acquisition costs. Alternatives include recognizing an asset recoverable through the various sources of cash flows described in paragraph 7(b) and amortizing it over the

period of receipt of those cash flows. Recognizing the incremental acquisition costs as a recoverable asset would:

(a) provide information several analysts have suggested is valuable.

(b) be roughly consistent with current US GAAP and with existing practice in several other countries, with the following exceptions:

(i) Only incremental costs related to acquired contracts would be capitalized.

(ii) The asset would be fixed in amount and would be amortized in accordance with the estimated cash flow recovered—no accretion or other benefit liability assumption effects would be would be permitted (as allowed/required under current US GAAP).

(iii) An onerous test would be needed to test whether the unamortized recoverable acquisition costs exceeded any remaining residual/composite margin.

(c) would not affect the contract cash flows at inception. However its recovery over time would affect the residual/composite margin as revenue was drawn down to offset the "amortization" of the deferred acquisition costs.

Staff recommendation

15. The boards have tentatively decided that an insurer should recognise acquisition costs as an expense when incurred. This paper recommends no change to that decision.

16. The majority of the staff would use the following approach: reduce the residual or composite margin at initial recognition (but not below zero) by the amount of incremental acquisition costs incurred. The insurer would achieve this either (a) by excluding that amount from the initial measurement of the margin (the approach taken in the recent staff draft) or (b) by including that amount in the

cash outflows. As a result, the insurer would recognise that amount as revenue at inception.

17. Some staff recommend the boards consider recognizing the right to recover incremental acquisition costs as a recoverable asset—ie recognized as an asset recoverable through the various sources of cash flows described in paragraph 7(b) and amortized over the period of receipt of those cash flows.

Question for the boards

Do you agree with the staff recommendations in paragraphs 16 (IASB reaffirm) or 17?

Appendix A: Consequences for the overall model

A1. 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.

A2. 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 in the measurement, on a probability-weighted cash flow basis (consistent with the IASB's approach in paragraphs A1 (a) and (b)). 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.