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International Accounting Standards Board

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **February 2006, London**

Project: **Insurance contracts (phase II):**
Summary of possible accounting approaches (Agenda Paper 10D)
Tabular comparison of accounting approaches (Agenda Paper 10E)
Acquisition costs (Agenda Paper 10F)

AGENDA PAPER 10D
Summary of possible accounting approaches

Purpose of this paper

1. This paper provides background for other papers for this meeting. It summarises the accounting approaches that the Board is considering for insurance contracts. Agenda paper 10E summarises them in a table.

2. This paper does not contain recommendations.

Background

3. In January 2005, the Board reviewed a project plan. As proposed there, we have so far attempted to identify appropriate accounting treatments for particular types of insurance contract, rather than trying to identify one accounting model for all accounting contracts. We intend to undertake a reconciliation exercise discuss at a later meeting (tentatively, April) to review, understand and assess any inconsistencies, if any, between the Board's preferences for different types of contract.

Terminology

4. As in previous discussions, this paper uses the following terminology:

   (a) The **claims liability** is the liability to pay valid claims for insured events that have **already** occurred, including claims incurred but not reported (IBNR).

   (b) The **pre-claims liability** is the stand-ready obligation to pay valid claims for **future** insured events arising under existing contracts, in other words, the obligation relating to the unexpired portion of risk coverage. (A more conventional name for this obligation is unearned premium, or unearned premium reserve. We have not used that name, to avoid pre-judging the decision on the measurement of this obligation.)

Overview

5. The approaches under consideration are as follows:

   (a) For non-life insurance:

      (i) pre-claims liabilities: either an unearned premium approach, or a prospective approach. The prospective approach would use either current entry value or current exit value.

      (ii) claims liabilities: a prospective approach (either current entry value or current exit value).

   (b) For life insurance liabilities: a prospective approach (either current entry value or current exit value). (For life insurance, claims liabilities are generally settled vary quickly, so there is little need to deal with them separately)

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

   (a) Non-life insurance (paragraphs 7-21)

   (b) Life insurance (paragraphs 22-36)

Non-life insurance

7. For non-life insurance contracts, the Board decided in May 2005 to explore two approaches in parallel for the time being, until it determines the basis on which one should be selected. The two approaches:

   (a) are identical in their treatment of the claims liability (paragraphs 8-10).

   (b) differ in their treatment of the pre-claims liability (paragraphs 11-21).

   (c) apply existing IFRSs (eg IAS 39) for assets held by insurers.

Claims liabilities

8. Under both approaches, non-life insurance claims liabilities would:

   (a) reflect current unbiased estimates of future cash flows. The staff believes this is uncontroversial.

   (b) reflect the time value of money. In other words, discounting would be required for all non-life claims liabilities. There would be no specific exemption for liabilities that meet particular criteria, but normal materiality criteria would apply.

   (c) include adjustments to reflect risk.

9. Neither the Board nor the Working Group has discussed whether the discount rate for claims liabilities should be current. However, if claims liabilities reflect current estimates, it seems logical that the discount rate should also be current.

10. We have not yet asked the Board to define the measurement attribute for non-life insurance claims liabilities. Instead, the discussion has focussed on various ingredients of a measurement attribute. We have identified two possible measurements that are consistent with the Board's tentative decisions in paragraph 8, namely current entry value and current exit value (both described later in this paper). We have identified no other suitable possibilities (paragraphs 31-34 assess possible arguments for approaches that use entity-specific estimates).

Pre-claims liabilities

11. The two approaches to non-life insurance liabilities differ in their treatment of the pre-claims liability:

    (a) The **unearned premium approach** measures the pre-claims liability as the unearned portion of the premium, less recoverable acquisition costs. Agenda paper 10F discusses whether the recoverable acquisition costs would be presented as an asset or as a deduction from the liability. The unearned premium (with related recoverable acquisition costs) would be subject to a liability adequacy test (agenda paper 10G). This test would involve discounting and include adjustments to reflect risk.

    (b) The **prospective** approach would measure the pre-claims liability in the same way as claims liabilities.

Further comments on the unearned premium approach

12. The unearned premium approach measures pre-claims liabilities as follows:

    (a) at initial recognition - at the customer consideration amount (less acquisition costs, if not presented as a separate asset) or, if higher, the amount determined by a liability adequacy test (see agenda paper 10G for discussion of such a test).

    (b) subsequently – at the portion of the customer consideration amount relating to the unexpired risks or, if higher, the amount determined by a liability adequacy test.

13. At inception, the unearned premium could be viewed as made up of the following three components (which are probably implicit, not explicit):

    (a) an estimate, at inception, of the future cash flows.

    (b) an adjustment to reflect the time value of money.

    (c) an adjustment for risk (an implicit risk margin).

14. Some view the unearned premium approach as analogous to the cost models used for some assets.

15. In some cases, unearned premium might not differ materially from current exit value or current exit value, but this may not always be the case, especially for longer-term or complex contracts or if circumstances have changed significantly since inception.

16. A prospective approach reflects both favourable and unfavourable changes in estimates, but an unearned premium approach reflects only unfavourable changes in estimates.

17. Once claims are incurred, the unearned premium approach no longer applies and a different measurement attribute is used for the claims liability.

Developments in the revenue project

18. One of the Board's main reasons for discussing two approaches for non-life contracts in parallel was to consider the implications of developments in the joint IASB and FASB project on revenue recognition. The Boards are currently exploring an approach with features that include the following:

    (a) Performance obligations would be initially measured at the allocated customer consideration amount, unless:

        (i) other accounting standards require measurement at fair value (as, for example, for financial liabilities).

        (ii) the obligation is an unconditional stand-ready obligation. The IASB has decided tentatively that such an obligation should be initially measured at fair value, even if it is the only obligation in the arrangement. Thus, for some arrangements, a reporting entity might recognise some revenue at the inception of the contract. On the other hand, the FASB has decided tentatively that unconditional stand-ready obligations should be measured at the allocated customer consideration amount (unless required to be measured at fair value by another accounting standard). The Boards intend to present both views in their discussion paper on revenue recognition.

    (b) For revenue contracts involving more than one unit of account, the total customer consideration would be allocated to each unit of account based on the price at which the underlying good, service or other right would be sold on a stand-alone basis. That price would be estimated by reference to the most reliable available evidence.

(c) When the allocated customer consideration approach is more fully developed, the boards may explore an alternative measurement principle that would permit or require a fair value measurement for any performance obligations that trade in active markets.

19. The Boards have not yet discussed some aspects of the approach under consideration in the revenue project, for example:

(a) Is there a liability adequacy test at inception and subsequently? If so, how does it work?

(b) Is any revenue attributed to advice given at the point of sale?

(c) Is interest accrued on the performance obligation?

(d) How is the customer consideration attributed to individual periods for contracts with complex features (eg stop-loss, deductibles, guarantees for which the risk fluctuates both up and down over time)?

Implications of the revenue project

20. As already noted, a non-life insurance contract creates an unconditional stand-ready obligation for the insurer. An initial measurement of that obligation at current exit value (using a prospective approach) could be consistent with the IASB's tentative conclusions for stand-ready obligations in the revenue project. On the other hand, an initial measurement at the customer consideration amount (unearned premium approach) could be consistent with the FASB's conclusions.

21. When it comes to subsequent measurement, developments in the revenue project may be inconsistent with one aspect of existing unearned premium approaches. The revenue project has concentrated on identifying performance obligations, with an entity recognising revenue when its performance discharges those obligations. In contrast, existing unearned premium approaches typically regard premiums as earned over the period during which insured events may occur. The following example illustrates the issue.

Background

An annual motor insurance contract is issued on 15 December X1. The contract provides insurance against insured events occurring from 1 January X2 to 31 December X2. The premium is 120, paid on 15 December X1. The expected (probability-weighted) present value of claims is 100. Claims are expected to arise evenly throughout the year and take six months to settle (average).

Unearned premium approach

Existing unearned premium approaches recognise the premium as revenue from 1 January X2 to 31 December X2.

Performance obligation approach

A performance obligation still remains at 31 December X2, because there is still some uncertainty then about the number and amount of valid claims. Therefore, this approach would attribute some revenue to X3.

In addition, a performance obligation approach might, arguably, attribute a small portion of the revenue to the period from 15 December X1 to 31 December X2. This would reflect the fact that the insurer has provided a promise during those 16 days of protection against changes in the price of insurance. Put differently, the insurer has assumed an obligation to stand ready to protect the policyholder against changes in the price of the contract.

Life insurance

22. In December 2005, in preparation for more detailed discussion in future meetings, the staff gave the Board an overview of four possible generic families of accounting models for life insurance contracts (two cost-based models and two current value models). The Board decided to focus future discussion on the current value models. The Board also had a preliminary discussion of contractual cash flows that depend on policyholder behaviour.

23. The two current value approaches discussed in December were current entry value and current exit value.

Current entry value

24. Current entry value is the amount that the insurer would charge to a policyholder today for entering into a contract with the same remaining rights and obligations as the existing contract. At inception, the measurement would be calibrated to the actual premiums incurred (and recoverable acquisition cost incurred). That calibration would act as a starting point for determining risk margins at later dates.

Is 'current exit value' the best description?

25. The papers for this meeting still use the terms 'current entry value' and 'current exit value' that we have used in previous meeting. Some view the difference as arising from a difference in reference markets (eg retail versus wholesale), rather than from a difference between entry prices and exit prices. The staff has not yet identified a better term, and would welcome suggestions.

Previous description of current entry value

26. The papers for the April 2005 meeting of the Insurance Working Group presented a slightly different version of current entry value. The April papers used the same definition ('the amount that the insurer would charge to a policyholder today for entering into a contract with the same remaining rights and obligations as the existing contract'). However, the detailed description placed more emphasis on the particular insurer's own pricing methodology. The measurement would have reflected items such as changes in estimates and changes in discount rates only to the extent that the insurer's own pricing methodology reflects them.

27. IWG participants did not generally favour that description, and some of them preferred a description along the lines given in this paper. The revised description was included in the models discussed at the September IWG meeting.

Current exit value

28. Current exit value is the amount that the insurer would expect to have to pay today to another entity if it transferred all its remaining contractual rights and obligations immediately to that entity (and excluding any payment receivable or payable for other rights and obligations, such as renewal rights). Because there is no secondary market for most insurance liabilities, that amount would need to be estimated.

Current entry value and current exit value compared

29. Both current entry value and current exit value:

    (a) reflect current unbiased estimates of future cash flows.

    (b) use a current risk-free market discount rate (possibly with some liquidity adjustment, a subject we plan to discuss at a future meeting).

    (c) do not recognise recoverable acquisition costs as a separate asset if the estimated cash flows that will recover the costs are considered in measuring the liability (agenda paper 10F).

    (d) use existing IFRSs to measure assets.

30. Current exit value and current entry value differ in the following respects:

    (a) Current entry value does not permit the recognition of a gain at inception (arguably, a loss might be recognised in some cases because of the liability adequacy test). In contrast, current exit value could lead to the recognition of a gain or loss at inception if the insurer concludes that the estimated secondary market price for risk and profit differs from the price that is explicitly or implicitly embedded in the premiums that it charges. In practice, some constraints might be put on recognising such gains or losses if there is little or no observable market data. For example, IAS 39 restricts the recognition of initial gains and losses that are not supported by 'comparison with other observable current market transactions in the same instrument (ie without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets.'[1]

    (b) For both current exit value and current entry value, the insurer recognises income as it is released from risk under the contract and provides services under the contract. However:

        (i) in current exit value, the margin after inception is the estimated margin that market participants would require for the remaining contractual obligations,

[1] IAS 39 appendix A, paragraph AG76

contractual rights and related risks. The margin would vary over time if there are changes in the estimate of the margin that market participants would require.

(ii) in contrast, current entry value calibrates the margin at inception to the observed transaction price with the policyholder (less recoverable acquisition costs incurred, if not presented as an asset). That margin reflects changes over time in the insurer's estimate of the **amount** of risk, but freezes the **per-unit price** of risk at inception.[2]

(c) Current exit value reflects the credit characteristics of the liability explicitly. Current entry value reflects those characteristics implicitly, or perhaps not at all. We plan to discuss this at a later meeting

(d) Current exit value does not include a liability adequacy test, because none is needed. Current entry value needs such a test at inception, but not later (agenda paper 10G).

(e) Embedded derivatives do not need to be separated from a 'host' insurance contract if the whole contract is measured at current exit value, with changes recognised in profit and loss. However, embedded derivatives might need to be separated from a host contract measured at current entry value, if current entry value is not close to current exit value.

Entity-specific estimates versus market estimates

31. Some accounting literature on measurement attributes distinguishes entity-specific estimates from estimates that other market participants would make. Therefore, some may wonder whether we should consider additional entity-specific measurement attributes as an alternative to current entry value and current exit value.

32. In the light of previous discussions with the Working Group, the staff intends to circulate separately an initial draft of guidance on estimates. That draft will reflect the Board's tentative decision in May 2005 that the project should clarify the measurement objective for insurance liabilities and give high level guidance on techniques for estimating the number and amount of claims arising under insurance contracts, but should not give detailed operational guidance.

33. In that draft, the staff intends to suggest that:

(a) estimates of variables that can be observed in, or derived directly from, markets (eg prices of publicly traded securities and interest rates) should be consistent with the observable market prices. The staff believes that this suggestion would have reasonable, though not unanimous, support in the Working Group. The degree of support may depend on how the guidance is worded.

(b) for estimates of variables that cannot be observed in, or derived directly from, markets (eg the frequency and severity of insurance claims and mortality), there will rarely, if ever, be persuasive evidence that distinction between entity-specific estimates and estimates of other market participants. For these variables, the distinction between entity-specific estimates and market has little practical significance.

(c) estimates of variables that cannot be observed in, or derived directly from, markets need to reflect the characteristics of the liabilities that are being measured. Thus, these estimates are necessarily **portfolio**-specific (for example, unbiased mortality estimates reflect, as far as possible, the demographics of the portfolio being measured). The fact that they are **portfolio**-specific does not make them **entity**-specific.

34. In the light of the preceding paragraph, it appears unnecessary to consider additional entity-specific measurement attributes.

Implications for other types of life insurance contract (including annuities and health)

35. This paper deals specifically with conventional non-participating term insurance contracts, but the discussion here ought to be equally relevant for conventional non-participating contracts of the following types:

(a) whole life contracts (ie contracts that pay a death benefit whenever death occurs, unlike a term contracts, which pays out only if death occurs during a period specified in the contract)

[2] Agenda paper 10G recommends that current entry value should be subject to a liability adequacy test at inception, but not subsequently.

(b) immediate life-contingent annuities (ie contracts that pay regular benefits for a period linked to the life of a specified person or persons)

(c) pure endowments (ie contracts that pay a benefit only if the policyholder survives until the contract matures).

(d) health insurance contracts.

(e) both single premium and regular premium versions of each of these contracts.

(f) life reinsurance contracts.

36. There may be additional considerations for the following types of contract, and we will consider them later:

(a) conventional non-participating endowments (ie contracts that pay a death benefit if death occurs during a period specified in the contract and pay a maturity benefit if the policyholder to the end of the specified period). These might be viewed as a combination of a financial instrument and a term insurance contract. We will consider this view separately when we discuss unbundling.

(b) conventional non-participating deferred life-contingent annuities with separate accumulation and payout phases (eg some pension contracts). Some of these might be viewed as (i) financial instruments in the accumulation phase and (ii) then insurance contracts in the payout phase. We will consider this view later.

(c) fixed (ie non-contingent) annuities. These are financial instruments. We have no specific plans to discuss them immediately. Once the Board begins to develop tentative conclusions for life-contingent annuities, we will identify differences, if any, between those conclusions and the existing treatment of fixed annuities. If any differences arise, we will consider the implications.

(d) participating (with profits) and unit-linking (variable) features. We will discuss these separately.

AGENDA PAPER 10E
Tabular comparison of accounting approaches

Summary of approaches – at inception			
	Unearned premium	*Current entry value*	*Current exit value*
Cash flows	Same overall result as current entry value, but cash flows, discount rate and margin not identified explicitly, except as needed for the liability adequacy test.	Unbiased estimate at inception	Unbiased estimate at inception
Discount rate		Market rate at inception (risk-free)	Market rate at inception (risk-free)
Margin		As implied by premium and acquisition costs (but could be overridden by a liability adequacy test)	Estimate of margin market participants would require at inception (could be close to entry value, but could differ)
Acquisition costs	Used in the initial measurement. Presentation to be discussed.	Used in calibrating initial margin. Not recognised as a separate asset. Implicitly reflected in liability cash flows to the extent pricing permits their recovery.	Not considered directly. Might be part of the evidence supporting the initial measurement. Implicitly reflected in liability cash flows to the extent pricing permits their recovery.
Can gain be recognised at inception?	No	No	Conceptually yes Include some constraints if reliability is in doubt?
Can loss be recognised at inception?	If liability recognition test identifies a loss	If liability recognition test identifies a loss	Conceptually yes May need further work to identify causes of apparent losses and consider their meaning.

Summary of approaches – at inception			
	Unearned premium	*Current entry value*	*Current exit value*
Liability adequacy test?	Yes (Portfolio level, details to be determined) Includes risk margin	Yes (Portfolio level, details to be determined) Includes risk margin	No (not needed)
Are embedded derivatives separated (if not 'closely related')?	Yes	Arguably not needed	No (not needed)
Credit risk inherent in the insurance liability	Arguably, implicit at inception	Arguably, implicit at inception	Explicit at inception

Summary of approaches– subsequent measurement			
	Unearned premium	*Current entry value*	*Current exit value*
Cash flows	Not re-estimated (unless unearned premium is inadequate)	Unbiased current estimate	Unbiased current estimate
Discount rate	Interest is not accrued (Implicit) discount rate does not change (unless unearned premium is inadequate)	Current market rate (risk-free)	Current market rate (risk-free)
Margin	Not re-estimated (unless unearned premium is inadequate)	Unexpired portion of the margin implied at inception The per-unit margin implied at inception is used in measuring both releases from risk (ie decreases in quantity of risk) and increases in quantity of risk.	Explicit estimate of current margin market participants would require Release from risk equals difference between explicit margins at one date and the next date
How is earned portion of margin for risk and profit determined?	To reflect • release from risk • provision of contractual services	To reflect • release from risk • provision of contractual services	To reflect • release from risk • provision of contractual services
Acquisition costs	Amortised in proportion to earned portion of premium Included in liability adequacy test	Not directly applicable (but acquisition costs affect initial calibration of the margin).	Not directly applicable

Summary of approaches– subsequent measurement			
	Unearned premium	*Current entry value*	*Current exit value*
Liability adequacy test?	Yes (with discounting and margins, portfolio level)	No (not needed)	No (not needed)
Credit risk inherent in the insurance liability		Arguably, unexpired portion of implicit margin at inception	Explicit, current assessment
Assets backing insurance liabilities (and related capital)	Existing IFRSs	Existing IFRSs	Existing IFRSs

Presentation of recognised income and expense			
	Unearned premium	*Current entry value*	*Current exit value*
Are premiums recognised as revenue?	Yes, when regarded as earned	To be determined (arguably, just deposit receipts)	To be determined (arguably, just deposit receipts)
Are claims recognised as an expense?	Yes, when incurred (including IBNR, incurred but not reported)	To be determined (arguably, just repayment of deposits)	To be determined (arguably, just repayment of deposits)
Is release from risk reported?	Implicit in earned portion of premium	Yes	Yes
Is interest accrued on non-life pre-claims liability?	No	Yes	Yes
Is interest accrued on non-life claims liability and life liability?	N/A	Yes	Yes

AGENDA PAPER 10F
Acquisition costs

Purpose of this paper

1. This paper discusses the treatment of acquisition costs for both life insurance and non-life insurance contracts.

Summary of staff recommendations

2. This paper recommends the following:

   (a) In a current entry value model or an unearned premium model, recoverable acquisition costs should be deducted in determining the initial measurement of the liability. (That may result in a debit for some premium contracts. Agenda paper 10B is relevant in determining whether that debit represents a recognisable asset.)

   (b) In a current exit value model, acquisition costs play no direct role, but they might play an indirect role as one piece of evidence that might help with estimates of the price that market participants might be prepared to receive (or pay) for the contractual rights and contractual obligations.

   (c) Recoverable acquisition costs should not be presented as a separate asset. The amount of such an asset would have no meaning, and any method of amortisation would be arbitrary.

   (d) The relevant acquisition costs are all costs incurred in originating the contract. These would be not just incremental costs, but also a systematic allocation [as in IAS 2] of other costs incurred in originating the contracts.

   (e) A future meeting should discuss how to present acquisition cost expense at inception.

Background

3. Insurers typically incur costs to sell, underwrite, and initiate a new insurance contract (often described as **acquisition costs)**. In many existing accounting approaches, acquisition costs meeting specified criteria are presented as an asset separate from the related insurance liability. The deferred acquisition costs are then amortised in a manner that is intended to match them with premium revenue (non-life insurance) or some other measure of performance (life insurance). Typically, that asset is described as **deferred**

acquisition costs. However, for reasons explained later, this paper uses the term **recoverable** acquisition costs.

4. In other approaches, recoverable acquisition costs are not presented separately. Instead, the related cash inflows affect the measurement of the liability.

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

   (a) Input from the Insurance Working Group (paragraph 6)

   (b) Acquisition costs in prospective approaches (paragraphs 7-16)

   (c) Acquisition costs in unearned premium approaches (paragraphs 17-19)

   (d) Defining the relevant acquisition costs (paragraphs 20-26)

   (e) Revenue and expense recognition (paragraph 27)

   (f) Background information – material from the appendix to IAS *Revenue*, dealing with costs of originating investment management contracts.

Input from the Insurance Working Group

6. At the Insurance Working Group, participants have generally seemed to agree on the following points:

   (a) The item traditionally called deferred acquisition costs is best viewed as a contractual right to recover costs incurred, not as a deferral of those costs. For convenience, this paper describes that right as **recoverable acquisition costs**.

   (b) If that contractual right is measured initially at cost:

      (i) its cost is more than just the incremental cost. Incremental costs are costs that the insurer would not have if the contract had not been issued, such as commission to intermediaries or employees.

      (ii) the right should be amortised (and related revenue recognised) on a basis that is not arbitrary. This probably implies that recoverable acquisition costs should not be recognised as a separate asset, but should instead be considered in the initial calibration of the liability.

Prospective approaches

Acquisition costs and current entry value

7. How do acquisition costs affect the measurement of an insurer's stand-ready obligation to pay contractual benefits? Insurers aim to price insurance contracts to provide an acceptable return after paying for claims and benefits, expenses and acquisition costs. If a book of insurance contracts is priced to be profitable and if experience under those contracts is in line with the pricing assumptions, the insurer's contractual rights will enable it to recover the acquisition costs incurred.

8. Consider a contract that generates policyholder benefits with a present value of CU 900 (including an acceptable risk margin). The insurer would want to charge at least CU 900 for this contract. Now suppose the insurer has to incur acquisition costs of CU 100 to originate the contract. The insurer will now want to charge at least CU 1,000 (plus some more if there is a time lag between payment of the acquisition costs and their recovery in premiums). Let's assume the contract has a single premium of CU 1,000, received at inception. The insurer's obligation still has a present value of CU 900, not CU 1,000. This suggests that, before considering the effect of any liability adequacy test, the current entry value at inception equals the premium received, less recoverable (and relevant) acquisition costs (paragraphs 20-26 discuss 'relevant').

Acquisition costs and current entry value

9. Acquisition costs play no direct role in a current exit value model. However, they might play an indirect role as one piece of evidence that might help with estimates of the price that market participants might be prepared to receive (or pay) for the contractual rights and contractual obligations. If all else is equal, an insurer would not willing transfer a contract to another insurer for a price that does not enable the insurer to recover its acquisition costs. Similarly, the hypothetical transferee would not need to recover acquisition costs that it has not incurred. Thus, it might be willing, if all else is equal, to take over the liability in the above example for CU 900, not CU 1,000.

Separate presentation of some contractual rights

10. If recoverable acquisition costs are recognised as a separate asset, the insurer will need to reduce the carrying amount of the asset as the insurer recovers acquisition costs. To do this, premium receipts would need to be split into a portion that increases the liability, a

portion that recovers acquisition costs and the remaining portion representing profit. Some accounting models do this by splitting each premium into these three components in fixed proportions. This approach (based on the US standard FAS 60) regards premiums as the main profit driver. This has the advantage that the split is reasonably objective and consistent, but the disadvantage that the assumption of a constant split over time is arbitrary and not related to anything in the contract itself. (For a few contracts, the split might be derivable from the surrender terms, but this is unlikely to be possible in general).

11. Other approaches amortise acquisition costs by reference to different profit drivers. For example, another US standard, FAS 97, uses an allocation mechanism based on estimated 'gross profit' (in essence, estimated explicit contractual margins plus estimated investment returns). This mechanism assumes that a constant proportion of the gross profit in each period is used to recover acquisition costs. Once again, this is an arbitrary assumption and not driven by anything in the contract.

12. As far as the staff is aware, most methods of recognising margins can amortise recoverable acquisition costs only by determining an overall net margin and then working back on a basis that would inevitably be arbitrary, or by making arbitrary splits of premium. The staff can see no informational benefit in presenting recoverable acquisition costs separately, rather than considering them in the measurement of the liability.

13. It is worth noting one difference between regular premium contracts (such as some life insurance contracts) and single premium contracts (such as many non-life insurance contracts).

    (a) At the inception of a regular premium contract, the insurer expects to recover acquisition costs from future premium receipts (except for a small portion recovered out of the first premium received at inception).

    (b) In contrast, for single premium contracts, the insurer expects to recover acquisition costs from margins included in a premium that it has already received. Thus, if recoverable acquisition costs are recognised as a separate asset, any allocation between the amortisation of recoverable amortisation costs and the release of margins is likely to be even more arbitrary than for regular premium contracts.

14. There might be some merit in investigating whether some contractual rights and obligations should be presented separately. For example, one approach might present the surrender value as one obligation, and the remainder of the contractual rights and obligations as an asset (if rights exceed obligations) or a separate liability (if obligations exceed rights). We will review that question when we look again at unbundling. However, any separate [net] asset identified would not (except by coincidence) equal the recoverable acquisition costs incurred. Thus, it seems unlikely that recoverable acquisition costs will play any role in identifying contractual rights or obligations that might be reported separately.

15. Some commentators appear to believe that recognition of a separate asset might take some pressure off the question of how to deal with the insurer's right to benefit from policyholder behaviour. However, in the staff's view, recognition of a separate asset would not help: the conceptual concerns that lie at the heart of the policyholder behaviour question would also be relevant in determining whether recoverable acquisition costs are a recognisable asset.

Recommendation

16. The staff recommends the following:

    (a) In a current entry value model, recoverable acquisition costs should be deducted in determining the initial measurement of the liability. (That may result in a debit for many regular premium contracts, for which acquisition costs sometimes exceed the premiums for more than one year. Agenda paper 10B is relevant in determining whether that debit is a recognisable asset.)

    (b) In a current exit value model, acquisition costs play no direct role, but they might play an indirect role as one piece of evidence that might help with estimates of the price that market participants might be prepared to receive (or pay) for the contractual rights and contractual obligations.

    (c) Recoverable acquisition costs should not be presented as a separate asset. The amount of such an asset would have no meaning, and any method of amortisation would be arbitrary.

Unearned premium approach

17. For the following reasons, in an unearned premium approach, some might argue that an insurer should present recoverable acquisition costs as an asset, not as a deduction in determining the initial measurement:

    (a) Separate presentation of deferred (recoverable) acquisition costs and of unearned premium is a long-standing practice, with which users are familiar.

    (b) The insurer has an asset representing the acquisition costs that it will recover out of future cash received, or out deferred receipts that will be recognised as revenue in future periods.

    (c) Deducting acquisition costs from the unearned premium implies that the portion of premium needed to recover the acquisition costs is already earned, even though it probably does not meet the revenue recognition criteria in IAS 18 *Revenue*.

18. Others might argue that:

    (a) As already discussed above, the entry value of the insurer's stand-ready obligation towards the policyholder is the initial premium received less the acquisition costs incurred.

    (b) There is no non-arbitrary basis for determining which portion of the revenue recognised in each period relates to recovery of acquisition costs.

Recommendation

19. The staff recommends that the initial measurement of the insurer's stand-ready obligation in an unearned premium approach should be the initial premium received, less recoverable acquisition costs.

Defining the relevant acquisition costs

20. As noted above, an accounting approach might deal with acquisition costs in various ways:

    (a) By deferring acquisition costs that meet specified criteria.

(b) By measuring the insurer's contractual rights initially at cost, with the acquisition costs being regarded as equal to that cost.

(c) By measuring an insurance liability initially at a market price calibrated to the entry value, with the entry value being regarded as the initial premium received at inception, less the acquisition costs.

21. Whichever of these approaches is adopted, it is necessary to define which acquisition costs are relevant for the treatment in question. In some approaches, deferred acquisition costs are deferrable only if they are incremental (ie they would have been avoided if the contract had not been issued), such as commission to intermediaries or employees.

22. The following precedents exist in IFRSs:

(a) In IAS 39 *Financial Instruments: Recognition and Measurement*, transaction costs are added to (deducted from) the fair value of a financial asset (financial liability) to determine the initial measurement of that financial asset or financial liability.[3] Transaction costs are 'incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability'.[4] They include 'fees and commissions paid to agents (including employees acting as selling agents), advisers, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs'.[5]

(b) In IAS 17 *Leases*, initial direct costs are 'incremental costs that are directly attributable to negotiating and arranging a lease (…)'. These costs are included in the initial measurement of finance lease receivables. They include 'amounts such as commissions, legal fees and internal costs that are incremental and directly attributable to negotiating and arranging a lease' and exclude 'general overheads such as those incurred by a sales and marketing team'.[6]

(c) Under IAS 32 *Financial Instruments: Disclosure and Presentation*, the transaction costs of an equity transaction are accounted for as a deduction from equity to the

[3] See IAS 39 paragraph 43.
[4] IAS 39, paragraph 9.
[5] IAS 39, paragraph AG13 of appendix A

extent they are incremental costs directly attributable to the equity transaction that otherwise would have been avoided.[7]

(d) Under IAS 18 *Revenue,* 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. The relevant guidance is in paragraph A14(b)(iii) of the appendix to IAS 18, and is attached in the appendix to this paper.

23. Those who would limit deferrable acquisition costs to incremental costs argue that accounting for a contract should include only those transactions and events that are directly relevant to that contract.

24. In some other approaches, deferrable acquisition costs include other costs that are not incremental, for example sales staff salaries and overheads attributable to the selling activity. Supporters of these approaches argue the following:

(a) Insurers price contracts in a way that is designed to recover all acquisition costs, not just that are incremental. It is misleading to report a loss at the inception of contracts that the insurer expects to be profitable.

(b) An insurer would not willing transfer a portfolio of insurance contracts to another party (or reinsure it in full) without seeking recovery of its acquisition costs. Moreover, in general, the transferee is willing to pay for the costs that it can avoid by acquiring a portfolio that is already assembled. (However, in some cases, a potential transferee may no longer be willing to compensate the transferor for its origination costs, for example if new distribution channels, such as the internet, reduce the cost of originating new business.)

(c) Unlike transaction costs, origination costs pay for a process that adds value to the instrument. An example of transaction costs would be a broker's commission for tradeable securities. If I buy securities, I incur commission, but nobody else will pay me for that commission if I sell the securities. In other words, the commission gives me a benefit (control of the securities), but adds no value to the securities. The costs

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[6] IAS 17, paragraphs 4 and 38.
[7] IAS 32, paragraph 37

incurred in originating a new instrument are different. For example, as already noted above, an insurer will try to price a product to recover its origination costs. Thus, if all else is equal, the origination costs pay for a process that adds value to the instrument. (Of course, it is still necessary to test whether the pricing actually allows those costs to be recovered.)

(d) The inclusion of overheads would be consistent with the inclusion of specified overheads in inventories. Under IAS 2 *Inventories*, the costs of inventories include 'include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods.'[8] '[I]t may be appropriate to include non-production overheads'[9], but the cost of inventories excludes 'administrative overheads that do not contribute to bringing inventories to their present location and condition'[10]

25. If the relevant acquisition costs are confined to costs that are incremental, the unit of account will be important (a subject for a future meeting). Costs that are incremental for a whole block of contracts may not be incremental for individual contracts.

Recommendation

26. An insurer would be expected to price a contract to recover all acquisition costs. Therefore, in the staff's view, the relevant acquisition costs are all costs incurred in originating the contract. These would be not just incremental costs, but also a systematic allocation [as in IAS 2] of other costs incurred in originating the contracts.

Revenue and expense recognition

27. We will discuss at a future meeting how acquisition costs should be presented at inception in a current entry value model or unearned premium model. There are two possibilities:

(a) recognised as an expense at inception, with a corresponding amount of income recognised at the same time. Some argue that the revenue recognition criteria in IAS 18 *Revenue* are not yet met at inception, because the insurer has not yet provided a service.

[8] IAS 2, paragraph 12
[9] IAS 2, paragraph 15
[10] IAS 2, paragraph 16

(b) deducted directly in determining the initial measurement of the liability (similar to the treatment under IAS 39 of transaction costs incurred in acquiring a financial instrument. This would mean that the acquisition costs would never be recognised as an explicit expense (though they would be included as an implicit component of risk margins released).

Appendix

Extract from the appendix to IAS 18 Revenue

14. Financial service fees

…

(b) Fees earned as services are provided.

…

(iii) 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.

The following points about the above guidance are worth noting:

(a) Only incremental costs are eligible for recognition as an asset.

(b) The asset represents the issuer’s contractual right to benefit from providing investment management services. The incremental costs are a measure of that asset, those costs are not themselves an asset.

(c) The recoverability of that asset may be assessed on a portfolio basis.

(d) In many cases, the asset is recoverable only if some policyholders continue to pay premiums. Thus there are interactions between the treatment of acquisition costs and the topic of continuation, cancellation and renewal options.

(e) The Board inserted this guidance in finalising IFRS 4 *Insurance Contract*. Commentators on ED 5 *Insurance Contract* had asked the Board to clarify how the deposit floor (roughly, the requirement that a financial liability is measured at not less than the amount payable on demand) interacts with transactions costs for long-term (non-insurance) savings contracts. This guidance built mainly on existing guidance in IAS 18 and IAS 11, the one new element being confirmation that recoverability could be assessed on a portfolio basis.