Project **Insurance contracts**

Topic **Acquisition costs**

## Purpose of this paper

1. This paper asks Working Group members for input on the treatment of acquisition costs.

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 (ie 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 intend to bring back the issue of acquisition costs to a future Board meeting, possibly July, to seek a common view on the accounting for acquisition costs. Accordingly, the staff is seeking the Working Group's input about the two key questions concerning the accounting for acquisition costs that differentiate the Boards' decisions:

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB working group identified in the header of this paper.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

(a) How should an insurer account for the part of the premium that covers acquisition costs?

(b) How should an insurer determine which part of the premium covers acquisition costs? (This question is relevant only if the response to (a) is that this part of the premium is viewed as other than part of the consideration for the insurance obligation.)

4. A brief analysis of each question follows (considering the tentative views of both boards to expense acquisition costs). We refer to the IASB April 2009 agenda paper concerning acquisition costs for background reading [a link to the observer notes for that agenda paper is included here].

## Analysis

### How should an insurer account for the part of the premium that covers acquisition costs?

5. One view is that part of the premium received is compensation for acquisition costs, not compensation for the insurance obligation itself. Proponents of this view believe that 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.

6. Another view is that the insurer should recognize revenue only when it satisfies its performance obligations under the contract. But at inception, the insurer arguably has not satisfied any of its obligations under the contract, so no revenue (or income) is recognized. Proponents of this approach argue 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, those who propose this approach might argue 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.

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

7. The view described in paragraph 5 recognises as revenue at inception the part of the premium that covers acquisition costs.  To apply that view, it is necessary to decide what acquisition costs are for this purpose.

8. 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*, limits transaction costs to incremental costs only - those costs that the insurer would not have incurred if it had not issued the particular contract.

9. 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 includes all costs that are directly related to the issuance of the insurance contract, not just the incremental costs.

10. 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. This approach is consistent with how IAS 39 determines deferred origination costs (see paragraph 8b) and arguably provides a principle that is less arbitrary than any other definition for acquisition costs.

11. On the other hand, some may argue that the principle of incremental acquisition costs is too narrow to adequately reflect the various distribution channels that insurers can use; it would probably result in different answers for different distribution channels even though those distribution channels may have the same cost level (eg external agents versus direct writing).

| **Question 1 for Working Group members** |
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| Which of the two views presented in paragraphs 5 and 6 do you prefer and why? |

| **Question 2 for Working Group members** |
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| Should acquisition costs be limited to the incremental costs of issuing the contract? Why or why not? If you believe it should not be limited to incremental costs, what basis do you prefer and why (please specify)? |