Project **Insurance Contracts**

Topic **Acquisition costs**

Purpose of this paper

1. The purpose of this paper is to discuss the treatment of insurance contract acquisition costs. This paper sets out:

   (a) previous decisions made by the boards and the reasons why the staff have brought the issue back to the boards

   (b) different ways of analysing the issue

   (c) a comparison with the proposals in the revenue recognition and other projects.

2. The staff does not have a common view on this issue. Each approach described in this paper has its supporters. Hence the paper includes no staff recommendation. In paragraph 33, the staff asks the boards to decide which of the following approaches they wish the ED to propose:

   (a) an insurer should recognise all acquisition costs as an expense when incurred and should not recognise a part of the premium as revenue (or income) at inception equal to the acquisition costs incurred (the boards' current decision)

   (b) the direct measurement of the contract liability should be calibrated to the premium excluding incremental acquisition costs

   (c) incremental acquisition costs should be included in the contract cash flows to determine the residual margin at the inception of the contract

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(d) an intangible asset should be recognised measured at the amount of incremental acquisition costs.

Previous decisions and reasons for bringing the issue back

3. Both boards have consistently held the view that insurers should recognise acquisition costs as an expense when incurred. However, the boards originally reached different tentative decisions about whether a part of the premium equal to the acquisition costs should be recognized at inception:

   (a) The IASB originally decided that an insurer should, at inception, recognize as revenue a part of the premium equal to 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 originally decided that an insurer should not recognize revenue (or income) at inception to offset those costs incurred.

4. At the October joint meeting, the boards affirmed that an insurer should recognise all acquisition costs as an expense when incurred. In addition, both boards decided tentatively that the insurer should not recognise a part of the premium as revenue (or income) at inception equal to the acquisition costs incurred. The FASB unanimously agreed to this decision, while the IASB voted 8-6 in favour of the decision. The arguments for this approach are that insurance acquisition costs are not given any special treatment but just expensed as incurred. The consideration from the customer is similarly treated consistently with other revenue in accordance with the proposals under the revenue recognition project.

5. The staff has brought the issue back for the boards to consider again for the following reasons:

   (a) when the boards discussed the issue in October, they were still discussing the extent to which the project should focus on consistency with the revenue

recognition project or should focus on direct measurement of the contract liability. Since then, the boards have affirmed that the measurement approach being developed for insurance contracts is a hybrid of (i) a direct measurement of the insurance liability and (ii) an allocation of a positive difference (if any) between expected premiums and cash outflows plus a risk margin on day one. The staff would like to explore the question of acquisition costs in that context.

(b) the responses to the field test questionnaire indicated that the boards' current proposal would have a significant effect for life insurers. Respondents argued that the proposals would not give useful information because:

(i) There is value creation on the sale of a contract and contracts are priced to recover acquisition costs (policies usually contain lapse penalties and/or early termination penalties to recover these costs).

(ii) An approach that recognises revenue to cover the acquisition costs acknowledges that the insurer expects the contract as a whole will be positive. It therefore better reflects the business model of insurers and the economics of the business.

(iii) The amount of the premium associated with the acquisition costs should be recognised in the same period the costs are incurred, which would reduce income statement volatility caused by the recognition of acquisition costs as expenses (ie big day one losses followed by inflated revenue / income in subsequent periods).

(iv) The inclusion of acquisition costs in the insurance liability cash flows and the day one profit calculation (resulting in the residual margin being net of acquisition costs) is consistent with European Embedded Value and the solvency requirements now being introduced in Europe (Solvency II).

(v) Canadian GAAP follows a similar principle to the alternative approach. All costs, including acquisition costs, are expensed as incurred and revenue is recognised to offset acquisition costs. Its application demonstrates that the approach originally proposed by the IASB is

workable and produces relevant and reliable information to users of financial statements.

This is consistent with feedback the staff has received from a wide range of interested parties, including some users as well as preparers.

(c) the analysis of policyholder accounting presented to the boards in February indicated that the current proposals on acquisition costs could not be applied symmetrically to policyholders (discussed further in paragraph 14).

(d) an analysis of the issue of ceding commissions paid by the reinsurer may not support the current proposals on acquisition costs (discussed further in paragraph 13).

6. Given these factors, the staff sets out below the following different ways of analysing the issue of acquisition costs:

(a) a focus on the direct measurement of the contract liability

(b) inclusion of acquisition costs in the cash flows of the contract

(c) recognition of a separate customer relationship intangible asset.

Direct measurement of the liability

7. Over the last few months, the boards have had several discussions comparing:

(a) the building blocks approach to measuring the liability (or asset) under an insurance contract with

(b) an approach that recognizes revenue over the period covered by the insurance and a liability for any claims.

8. The boards are pursuing the building blocks approach, which includes a direct measurement of the contract liability. The building blocks are:

(a) the unbiased, probability-weighted average of future cash flows expected to arise as the insurer fulfils the contract;

(b) the effect of time value of money;

(c) a risk adjustment for the effects of uncertainty about the amount and timing of future cash flows; and

(d) an amount that eliminates any gain at inception of the contract (a residual margin). The residual margin cannot be negative.

9. Getting the best possible measure of the contract liability is one of the main objectives of the project. Consider the following simple example, which ignores the time value of money, of an insurance contract which the insurer has priced at a single premium of 100 to cover:

Expected cash outflows	65
Risk adjustment	15
Acquisition costs	20
Total	100

10. Under the boards' proposals, the insurer would recognise:

(a) a liability of 100 equal to the expected cash outflows (65), risk adjustment (15), and residual margin to prevent a day one gain (20), and

(b) an expense for acquisition costs of 20.

11. The staff thinks that it is important to note that the element of the insurance measurement approach that represents the direct measurement of the liability includes only expected cash flows, time value of money and risk-adjustment. The residual margin provides a method of calibrating the measurement of the liability to the premium. We do this because the premium is an amount that can be observed reliably in transactions.

12. We can get closer to a direct measure of the liability by calibrating the measure to the premium excluding items that we know do not arise from the remaining liability. So in the above example we could get closer to a direct measure of the

liability by calibrating to the premium excluding the amount that was included to cover direct acquisition costs. That would result in no residual margin and a total liability of 80.

13. Such a reduced measure for the liability is consistent with the fact that reinsurers typically charge a reduced premium or pay a ceding commission to take on the liability. In the above example, a reinsurer taking on the liability would charge 80 rather than 100. The reinsurer does not need to cover the cedant's direct acquisition costs.

14. Similarly, if the policyholder made the same assessment of cash flows and risk-adjustment as the insurer, it would in principle recognise an asset of 80 (expected cash inflows and risk adjustment). There would be symmetry in the measurement of the contract. (In practice, a policyholder would not enter into such a contract if its assessments of cash flows and risk-adjustment were the same as the insurer's. If a policyholder enters into such a contract, it must be because its assessment of the cash flows and risk-adjustment is at least 100. It would not enter a contract that gave an immediate economic loss.)

15. Further, excluding acquisition costs from the premium when calibrating the liability is consistent with the board's decision on the lessor's treatment of lease initial direct costs. The board decided that these costs should be added to the lessor's receivable, ie to the contract asset. This reflects the fact that the lessor will price the lease so that the interest rate implicit in the lease covers the initial costs as well as the time value of money, expected defaults and risk of additional defaults. Including the acquisition costs in the lessor's contract asset is equivalent to reducing the initial measurement of the insurance contract liability by the insurance acquisition costs. In both cases, the accounting acknowledges the fact that the contract price includes an amount to cover the acquisition costs.

16. Of course, the above example is over-simplified. In practice, there will often be a residual margin even if we exclude acquisition costs. Nor is it always possible to assess exactly how the premium has been set. So the question is whether excluding acquisition costs from the premium gives a sufficiently reliable benchmark for calibration.

17. For the calibration benchmark to be reliably observable, the amounts excluded from the premium should themselves be reliably observable. In principle, we should exclude not the amount of the acquisition costs themselves, but the amount included in the premium to cover those costs. However, the staff thinks that determining this amount would be too subjective and not reliably observable. Instead we should focus on the costs themselves as a proxy. The staff thinks that whether they give a reliable benchmark depends on what acquisition costs we would require to be excluded from the premium.

18. In previous discussions on acquisition costs, staff identified the following two approaches to identifying acquisition costs:

    (a) Acquisition costs should be defined as the incremental costs of issuing an insurance contract. This approach is for example consistent with how IAS 39 *and IFRS 9* determine transaction costs for financial instruments 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).

19. The IASB previously had 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. Some staff still believe 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. On the other hand, the staff acknowledges that incremental costs may be more reliably observable.

Cash flows of the contract

20. This approach takes the view that that at least some acquisition costs are part of the cash flows under the contract and should therefore be treated in the same way as any other cash flows under the contract. At the moment of inception of the contract no cash flows have yet occurred. They are all still in the future. This is particularly true if the contract has recurring acquisition costs throughout the life of the contract. Any future instalments of the recurring acquisition costs, at least to the extent of the incremental costs, would be included in the contract cash flows. This suggests that any initial costs should be treated in the same manner.

21. The simple example used above would be analysed as follows at the point of inception:

Expected cash outflows (including acquisition costs of 20)	85
Risk adjustment	15
Total	100

22. On this fact pattern, no residual margin arises at the inception of the contract, and the liability is measured at 100. Once the acquisition costs have been paid, perhaps within hours of the contract inception, the liability reduces to 80. At this point, this approach is effectively the same as the approach that calibrates the margin at inception to premium less acquisition costs. However, some may find a cash flow approach more intuitive than a liability measurement approach. The staff understands that in some jurisdictions actuaries have traditionally regarded the acquisition costs as contract part of the contract cash flows.

23. The staff notes that under this approach, the cash flows can include only those acquisition costs that are incurred at or after the contract inception. The staff thinks this limits the acquisition costs to be treated in this way to incremental costs.

Recognition of a separate customer relationship intangible asset

24. Both of the above approaches focus on the measurement of the contract. The third alternative takes the view that acquisition costs could be viewed as giving rise to a separate intangible asset (for example, a customer relationship asset).

25. So the example used above would be analysed as:

Expected cash outflows	65
Risk adjustment	15
Residual margin	20
Total	100

26. The insurer would recognise a liability of 100 and an intangible asset of 20. Of course the acquisition costs themselves are not an asset. But the insurer obtains a benefit from incurring those costs, the relationship with the customer. If we think the acquisition costs are not part of the contract (because the cash flows are not between the insurer and the customer) we need to recognise that benefit separately from the contract. The intangible asset represents the benefits expected to arise from the customer over the life of the contract. The existence of such an asset is supported by the fact that insurers will pay to buy books of insurance business. The intangible would be amortised over the coverage period. The intangible asset does not reflect the possibility of future contracts.

27. Under this approach, in principle we should be trying to determine the value of the intangible asset. However, in order to get a reliable measure, we look to acquisition costs as a proxy. As with liability measurement approach, some staff think 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 benefit. On the other hand, as before, the staff acknowledges that incremental costs may be more reliably observable.

Income statement presentation and consistency with the revenue recognition and other projects

28. The above discussion of the approaches focuses on the liabilities and assets that would be recognised. This section looks at how the approaches might be presented in the income statement and the question of consistency with the revenue recognition and other projects.

29. Using the same example as before, the approaches would give rise to the following effect in income:

    (a) Liability measurement at inception: Dr cash for premium 100, Cr cash for acquisition costs 20, Cr contract liability 80. There is a nil net effect on the income statement. Under the expanded presentation approach, at inception an entity would recognise expense of 20 and revenue of 20.

    (b) Contract cash flows: At inception of contract, Dr cash for premium 100, Cr contract liability 100. When incremental acquisition costs are incurred (which in practice may often be at inception), Dr contract liability 20, Cr liability for acquisition costs (eg broker's commission) 20. There is nil net effect on the income statement. Under the expanded presentation approach, an entity would recognise expense of 20 and revenue of 20 when the acquisition costs are incurred. When acquisition costs are paid, Dr liability for acquisition costs 20, Cr cash 20.

    (c) Separate asset: Dr cash for premium 100, Cr contract liability 100. Dr intangible 20, Cr cash for acquisition costs 20. There is no effect on the income statement. The intangible would be amortised over the coverage period of the contract. Revenue would be recognised as proposed under the expanded presentation approach.

30. Applying the expanded presentation approach to (a) and (b) means that revenue is recognised at the same time as the acquisition costs, ie on inception of the contract or almost immediately thereafter. The staff appreciates that this seems in conflict with the proposals in the revenue recognition project, and that consistency with the revenue recognition project has been an important factor in the board's previous decisions on insurance acquisition costs.

31. However the staff notes that the objective of the insurance contracts project differs from that of the revenue recognition project. The insurance contracts project focuses on the explicit measurement of an insurance contract. In contrast, the revenue project does not focus on explicitly measuring a contract with a customer. Rather, the proposed revenue model requires an entity to allocate the transaction price to the performance obligations. The model does not allocate any of the transaction price to costs that are not part of the performance obligation because the boards were uncomfortable recognizing revenue before the entity had transferred goods or services to the customer.

32. Some staff members think that the focus in approaches (a) and (b) on the measurement of the contract liability/cash flows justifies a departure from the proposals in the revenue recognition project. Further the staff notes that reducing the contract liability by, or recognising an asset for, the acquisition costs is consistent with the boards' decision for lessor initial direct costs.

Staff conclusion

33. The staff does not have a common view on this issue. Each approach has its supporters.

Question 1 for the boards
Which approach should the ED propose for acquisition costs? (a) an insurer should recognise all acquisition costs as an expense when incurred and should not recognise a part of the premium as revenue (or income) at inception equal to the acquisition costs incurred (the boards' current decision) (b) The direct measurement of the contract liability should be calibrated to the premium excluding incremental acquisition costs (c) Incremental acquisition costs should be included in the contract cash flows to determine the residual margin at the inception of the contract (d) An intangible asset should be recognised measured at the amount of incremental acquisition costs.