Staff Paper

Project	**Insurance contracts**
Topic	**Acquisition costs**

What is this paper about

1. The purpose of this paper is to ask the boards to determine the accounting for acquisition costs for insurance contracts.

Staff recommendation

2. The staff recommend that:

   (a) For contracts issued, some acquisition costs should be included in the initial measurement of insurance contracts as contractual cash flows and all other acquisition costs should be expensed as incurred.

   (b) The acquisition costs included in the cash flows of insurance contracts should be limited to those that are direct and incremental at the portfolio level for the sales force contract selling, underwriting, medical and inspection, and policy issuance and processing functions.

   (c) Implementation guidance should be provided to clarify the types of acquisition costs that would be included in the cash flows of insurance contracts.

3. As discussed in Appendix A, including only acquisition costs in the contractual cash flows that are direct, incremental, and recoverable is similar to the staff's recent recommendation in the revenue recognition project.

4. The remainder of this paper is organized as follows:

   (a) Background (paragraphs 5—30)

      (i) Summary of the proposals in the IASB's exposure draft *Insurance Contracts* (ED) and the FASB's discussion paper *Preliminary Views on Insurance Contracts* (DP)

      (ii) Basis for decisions

      (iii) Recent FASB guidance in Accounting Standards Update 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts* (Update 2010-26)

      (iv) Relevant questions in the ED and DP

      (v) Overview of comments received on the ED and DP

      (vi) Alternatives to the proposals in the ED and DP

   (b) Staff analysis and recommendation (paragraphs 31—47)

   (c) Appendix A – Decisions relating to acquisition costs in other projects

   (d) Appendix B – Recent FASB guidance in Update 2010-26 issued for acquisition costs of insurance contracts.

Background

Summary of the proposals in the ED and DP

5. The ED and the DP state that, at initial recognition, an insurer would:

   (a) Include incremental acquisition costs in the present value of the fulfilment cash flows

   (b) Recognise all acquisition costs other than those identified in (a) as an expense when incurred.

6. Acquisition costs are defined in the ED as "the costs of selling, underwriting and initiating an insurance contract" and in the DP as "the direct and indirect costs of selling, underwriting and initiating an insurance contract."

7. Acquisition costs would be included in the cash flows used to measure insurance contracts only for those contracts that have been issued and that the insurer has incurred because it has issued those particular contracts (that is, those costs that would not have been incurred if the insurer had not issued those particular contracts).

8. The incremental acquisition costs would be identified at the level of an individual insurance contract. Acquisition costs included in the cash flows of insurance contracts would reduce the residual (or composite) margin at initial recognition of the contract. Accordingly, acquisition costs would not be explicitly amortized, but rather, would affect profit over the coverage period (residual margin) or over the coverage and claims handling periods (composite margin).

Basis for decisions

9. The IASB's 2007 discussion paper *Insurance Contracts* proposed that an insurer recognize acquisition costs as an expense and recognize revenue at an amount equal to the portion of the premium that relates to recovery of the acquisition costs. However, if an insurer is selling insurance coverage, none of the premium is earned until that insurer has actually provided that coverage. Therefore, it would not be appropriate to recognize revenue to offset acquisition costs as that revenue will not have been earned by the insurer. Furthermore, the policyholder pays a premium for insurance coverage and would not consider the insurer to have earned any of that premium (provided any coverage) solely based upon acquisition of the contract.

10. The boards had considered whether acquisition costs should be reported as an asset but had determined that deferring acquisition costs as an asset would report an asset that either (a) does not exist (if the insurer recovers acquisition costs from cash already received) or (b) relates to future cash flows that should be included in the measurement

of the contract. Additionally, the boards believed the pressure to recognize such an item as a separate asset arose from an overstatement of the insurer's obligation.

11. In October 2009, the boards decided that an insurer should recognize all acquisition costs as an expense when incurred without recognizing a part of the premium as revenue (or income) equal to the acquisition costs incurred. The boards decided against this decision because respondents to the initial field test questionnaire did not believe it would result in useful information because:

    (a) Value is created upon the sale of a contract and contracts are priced to recover acquisition costs.

    (b) Insurers expect contracts to be profitable and acquisition costs would not typically result in a loss at initial recognition of an insurance contract. Therefore, expensing acquisition costs as incurred does not reflect the business model.

    (c) The recognition of acquisition costs as incurred would result in income statement volatility (that is, day one losses followed by revenue in subsequent periods).

12. In deciding to include acquisition costs as contractual cash flows, the boards believed an insurer typically charges a policyholder a price that the insurer regards as sufficient to compensate for undertaking the obligation to pay for insured losses and the cost of originating the contract. As such, a faithful representation of the remaining obligation would not include the portion of the premium that paid for the acquisition costs. If the contract pricing is insufficient to recover the acquisition costs, a loss would arise at initial recognition because the residual (or composite) margin could not be negative.

13. The boards proposed to limit the acquisition costs to be included in the cash flows to incremental costs because those costs can be clearly identified as relating specifically to the contract. Determining whether other costs are directly related to the contract can be more subjective and lead to differences in practice.

Recent FASB guidance in Update 2010-26 issued for acquisition costs of insurance contracts

14. In October 2010, the FASB issued Update 2010-26, which is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. Under Update 2010-26, an insurance entity shall capitalize only the following as acquisition costs related directly to the successful acquisition of new or renewal insurance contracts:

(a) Incremental direct costs of contract acquisition.

(b) The portion of the employee's total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing any of the following acquisition activities for a contract that actually has been acquired:

(i) Underwriting

(ii) Policy issuance and processing

(iii) Medical and inspection

(iv) Sales force contract selling.

(c) Other costs related directly to the insurer's acquisition activities in (b) that would not have been incurred by the insurance entity had the acquisition contract transaction(s) not occurred.

(d) Advertising costs that meet the capitalization criteria in Subtopic 340-20, *Other Assets and Deferred Costs—Capitalized Advertising Costs* (that is, the costs of direct-response advertising shall be capitalized if the primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising and the direct-response advertising results in probable future benefits).

15. Update 2010-26 provides implementation guidance on the incremental direct costs of contract acquisition that may be deferred and costs that should be expensed. Refer to Appendix B.

Relevant questions in the ED and DP

16. Question 7 of the ED asked respondents the following:

> Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognized as expenses when incurred? Why or why not? If not, what do you recommend and why?

17. Question 13 of the DP asked respondents the following:

> Do you think that acquisition costs should be included as one of the cash flows relating to the contract? If not, how would you account for acquisition costs?

18. Question 14 of the DP asked respondents the following:

> Do you agree that acquisition costs included in the cash flows used in the measurement of the insurance contract should be limited to those that are incremental at the individual contract level? If not, which acquisition costs, if any, would you include in the measurement of the insurance contract?

Overview of comments received on the ED and DP

Whether to include acquisition costs as one of the cash flows in the initial measurement of an insurance contract

19. Most respondents believe acquisition costs should be included as one of the cash flows included in the initial measurement of an insurance contract. Some of those respondents noted that treatment is consistent with the pricing of an insurance contract, which is generally determined to recover those costs through future premiums and surrender charges. Some respondents suggested that a faithful representation of the remaining obligation should not include the part of the premium that paid for the acquisition costs.

20. Some respondents raised concerns about the inconsistency in the treatment of acquisition costs between the boards' proposals for insurance contracts and for other outstanding projects including revenue recognition, leases, and financial instruments

and that the boards should address the issue holistically rather than on a project by project basis.

Which acquisition costs to include in the initial measurement of an insurance contract

21. Most respondents believe the proposed definition of acquisition costs is too narrow and are opposed to the restriction to costs that are incremental at the individual contract level because that would exclude many of the costs of obtaining and underwriting new contracts.

22. Some respondents noted that restricting acquisition costs to those that are incremental at the contract level would result in differences in the acquisition costs included in the measurement of an insurance contract depending on an entity’s distribution system (that is, whether the entity performs contract acquisition service in-house and incurs internal agents’ commissions and/or salaries or sources services externally and pays commissions to third-party agents) and sales compensation plans (that is, commission-based versus salary-based). As such, different liability values could result amongst insurers based on how the contracts were distributed, even if the form of distribution has no effect on the expected future cash flows or on the obligations of the insurer.

23. Most respondents suggested that acquisition costs be determined at the portfolio level to be consistent with the unit of account used for measurement throughout the proposed models. In addition, many believe that costs incurred in the underwriting and new business departments, which are vital to the acquisition of new business, cannot be directly linked to an individual contract, but that entities would be able to link those costs to a portfolio of contracts.

24. Several respondents believe that the portfolio level is consistent with how insurers price and manage their business. Inherent in the pooling of insurance risk and the creation of portfolios of insurance contracts is a need to underwrite a large number of applications so that they can be appropriately evaluated based on characteristics of risk and that sufficient volume is achieved for pooling to work.

25. Many respondents believe the guidance in Update 2010-26 is appropriate and should be used in the final standard for insurance contracts. A few of those respondents believe that alignment of the definition of acquisition costs with Update 2010-26 would result in an expansion of the proposed definition to include costs such as underwriting, medical examinations, policy issuance, and certain direct response advertising costs. Those respondents believe that the guidance in Update 2010-26 is more reflective of the nature of acquiring new business and encompasses more critical components of acquiring new and renewal business than the proposed definition.

26. Many respondents requested further clarification of the types of acquisition costs that would be included in the cash flows used to measure an insurance contract, specifically:

   (a) Timing - Some respondents questioned whether incremental acquisition costs incurred before initial recognition but necessary to acquire and initiate a contract would be included in the measurement of an insurance contract.

   (b) A few respondents commented that the costs of direct-response advertising that meet certain criteria should be included as incremental acquisition costs in the present value of the fulfilment cash flows. These respondents suggested including U.S. GAAP language regarding the capitalization of advertising costs (that is, the costs of direct-response advertising shall be capitalized if both of the following conditions are met: (a) the primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising; (b) the direct-response advertising results in probable future benefits).

   (c) Some respondents noted that there is current diversity in practice and that implementation guidance, similar to that included in US GAAP, should be included in the standard.

   (d) A few respondents noted inconsistencies within the ED regarding the costs that would be included in the initial measurement of a contract. For example, paragraph B61 seems to limit incremental cash flows to costs that relate directly to insurance contracts or contract activities, while subparagraphs B61(f) and B61(g) seem to exclude general overheads relating to policy issuance. Those respondents note that they believe the boards intended for costs of underwriting to be included in the liability measurement, but those costs are generally incurred on all contracts regardless of whether the contract was actually issued and therefore, would not be incremental at the contract level.

(e) A few respondents noted that subparagraph B61(f) of the ED which states that incremental costs are costs that the "…insurer has incurred because it has issued that particular contract…", may lead to the interpretation that these costs could exclude functions such as underwriting and medical/inspection fees because these costs are incurred regardless of whether a contract was placed even though the ED states that relevant cash flows to be included in the liability measurement include, "the incremental costs of selling, underwriting and initiating an insurance contract for those contracts that have been issued".

(f) Volume - whether the incremental costs of selling, underwriting, and initiating a group of contracts would be included in the initial measurement of an insurance contract if those costs cannot be identified at the individual contract level.

(g) Volume - some commissions are paid annually based on the premiums for new business sold or once the agent has reached a certain scale. These commissions are incremental but are not measured at an individual contract level.

27. A few respondents agreed that acquisition costs should be determined at the contract level. Some of those respondents noted that the principle of incremental costs at the contract level is used in other areas and has been reliably implemented.

28. A few respondents suggested that only incremental, policy-specific costs that are recoverable (can be recouped in case of cancellation of a contract) should be included in the initial measurement of the insurance contract.

Alternatives to the proposals in the ED and DP

29. Most respondents supported including incremental acquisition costs (for contracts issued) in the initial measurement of insurance contracts as contractual cash flows. However, a few respondents suggested that acquisition costs be presented separately instead of netting those costs against the expected cash flows.

30. Respondents suggested several alternatives for which acquisition costs should be included in the cash flows used in the measurement of insurance contracts. Some of those alternatives are as follows and are discussed further below:

    (a) Alternative 1—Acquisition costs included in the contractual cash flows of insurance contracts should be limited to those that are direct and incremental at the individual contract level (as proposed).

    (b) Alternative 2—Acquisition costs included in the contractual cash flows of insurance contracts should be limited to those that are direct and incremental at the portfolio level.

    (c) Alternative 3—Acquisition costs included in the contractual cash flows of insurance contracts should be consistent with the definition and clarifications for acquisition costs in Update 2010-26.

    (d) Alternative 4—Acquisition costs included in the contractual cash flows of insurance contracts should be limited to those that are not only direct and incremental, but also, recoverable (that is, costs that may be recouped in case of cancellation of a contract).

Staff analysis and recommendation

Whether to include acquisition costs as one of the cash flows in the initial measurement of an insurance contract

31. A few respondents suggested presenting acquisition costs separately from the expected cash flows. The staff agrees with the boards' previous decision that deferring acquisition costs as an asset would report an asset that either (a) does not exist (if the

insurer recovers acquisition costs from cash already received) or (b) relates to future cash flows that should be included in the measurement of the contract.

Which acquisition costs to include in the initial measurement of an insurance contract

Alternative 1—Acquisition costs included in the contractual cash flows of insurance contracts should be limited to those that are direct and incremental at the individual contract level (as proposed)

32. As noted above, if the acquisition costs included in the contractual cash flows of the insurance contract are limited to those that are incremental at the contract level, there would be different results depending on an entity’s distribution system and sales compensation plans. Forms of distribution commonly used by insurers include distribution by independent brokers, by employees or agents who are not independent, and by direct response marketing (such as over the internet). Each form of distribution has different mixes of acquisition costs that are incremental at the contract level and incremental at the portfolio level.

33. Additionally, there are a number of types of acquisition expenses that are incremental acquisition expenses and that can be tied directly to new business of a portfolio, but cannot be tied directly to an individual contract. Examples include underwriting and issue costs, expense allowances to career agents, and volume or success bonuses that are dependent on aggregate sales level.

34. The staff does not believe that the accounting results should be different depending on the distribution channels of the insurer. In addition, the staff does not believe that underwriting and policy issuance costs that cannot be directly linked to an individual contract should be expensed as incurred, as these are integral costs to the acquisition of an insurance contract and have future value.

Alternative 2—Acquisition costs included in the contractual cash flows of insurance contracts should be limited to those that are direct and incremental at the portfolio level

35. Including incremental acquisition costs in the contractual cash flows of the insurance contract that are incremental at the portfolio level would resolve concerns regarding different treatment depending on an entity’s distribution system whether it be by

independent brokers, by employees or agents who are not independent, or by direct response marketing. The portfolio level is consistent with how insurers price and mange their business. Many of the acquisition costs incurred by insurers – such as underwriting, medical and inspection, and policy issuance – are measured and managed at the portfolio level, rather than at the individual contract level. Additionally, including incremental acquisition costs in the contractual cash flows of the insurance contract that are incremental at the portfolio level would be consistent with the unit of account used for measurement throughout the proposed models.

36. Expanding the proposals to measurement at the portfolio level also would clarify that certain costs that may not be able to be linked to individual contracts, such as expenses associated with underwriting and policy issuance and processing, would be included in the costs to be included in the expected cash flows. For example, the salary of an employee who performs tasks related to policy issuance generally is not attributable to the sale of any particular contract. In addition, many of these costs are incurred prior to the actual issuance of a policy, such as underwriting and medical and inspection costs. However, a portion of these expenses are directly related to the acquisition of new business, and they would be expected to increase as sales increase at the portfolio level. Therefore, the staff believe that it is appropriate to include such costs in the measurement of insurance liabilities and recommend that acquisition costs included in the cash flows of an insurance contract be determined at the portfolio level.

37. If the boards decide to include incremental acquisition costs at the portfolio level, two additional questions need to be addressed:

(a) Should the incremental acquisition costs be limited to those only for contracts issued?

(i) Inherent in the pooling of insurance risk and the creation of portfolios of insurance contracts is a need to underwrite a large number of applications so that they can be appropriately evaluated based on characteristics of the risk and that sufficient volume is achieved for pooling to work. In that process, it is expected that a portion of the applications will not result in the placement of an insurance contract, either because the application will be rejected by the insuring entity or the applicant will refuse the final offer made by the insuring entity. Included in the insurers pricing and how they manage their business are certain costs regardless of whether the contract is issued or not.

(ii) Some believe that a distinction between successful and unsuccessful efforts, while justifiable in a cost-deferral approach to measurement, would not be relevant to an approach based on the cash flows expected to fulfil the contract. . The objective of the measurement model is to measure the remaining obligation at inception by reference to what the policyholder paid after excluding what the policyholder implicitly paid for the acquisition effort. At a portfolio level, the amounts paid for the acquisition effort includes costs related to both successful and unsuccessful efforts. Therefore those with this view argue that, if the definition of incremental acquisition costs includes costs incremental at the portfolio level, all such costs should be included in the present value of fulfilment cash flows.

(iii) Some believe insurers should include in the fulfilment cash flows only incremental acquisition costs related directly to the successful acquisition of new or renewal insurance contracts. Including unsuccessful efforts in the contractual cash flows could hinder comparability amongst insurers. For example, if one insurer is more efficient in writing successful contracts than another insurer and obtains 80 percent of efforts as successful contracts while another insurer only obtains 50 percent as successful contracts, those insurers will not have comparable measurement of insurance contracts at initial recognition and in subsequent periods because of the effect on the residual (or composite) margin of including acquisition costs in the contractual cash flows. In addition, some question the conceptual basis for how costs relating to unsuccessful contract acquisition efforts could be considered to provide a future economic benefit to warrant recognition and can be considered to be recoverable and therefore believe incremental costs should be limited to those only for contracts issued.

(iv) The staff, while sympathetic to a.ii., do not believe that costs relating to unsuccessful efforts have a future benefit and although future benefit is a defining characteristic of an asset, the answer should not be different when recorded as part of the cash flows as a contra-liability. This is consistent with the boards apparent intent in the basis for conclusions in the ED which proposed to limit the acquisition costs to be included in the cash flows to those costs that can be clearly identified as relating specifically to contracts issued. Therefore, the staff recommends that the costs included in the cash flows related to acquisition costs should only be those for successful insurance contracts.

(b) Should the incremental acquisition costs for contracts issued be limited to those that are direct versus all incremental costs at the portfolio level?

(i) The cash flows that arise from an insurer fulfilling the contract include both direct acquisition costs, such as underwriting, sales commissions, and policy issuance and indirect acquisition costs that are associated with performing the acquisition functions, many of which are necessary. Such costs may include rent for the building occupied by a sales force, administrative costs, depreciation, occupancy, equipment, and other general overhead costs. In addition, the insurer incurs costs for soliciting potential customers, market research, and product development. All of these costs are part of the amounts paid for the acquisition effort and thus excluding these costs from the measurement of the liability at inception meets the objective of an expected cash flow model. Therefore some believe all of the costs associated with the acquisition functions should be included in the present value of fulfilment cash flows.

(ii) Similar to other industries, insurers price their products to recoup all of their costs and make a profit. The question becomes where the cut-off should be the further the functions and costs are from the direct interaction with the policyholder and the application and written policy. Every business has base functions and costs to operate. Subjectivity is needed to determine how to split step variable costs between the base operations and the costs that are associated with additional business. In addition, determining whether other costs are directly related to the contract can be more subjective and lead to differences in practice.

(iii) Based on the above arguments, the staff does not believe that all costs included in the pricing of a policy should be captured as acquisition costs and similar to other industries there should be certain period costs. The staff recommend that the costs to be included in the cash flows for acquisition costs be limited to those costs that are direct and incremental at the portfolio level and relate to the acquisition functions (that is, sales force contract selling, underwriting, medical and inspection and policy issuance and processing).

38. Alternative 3—Acquisition costs included in the contractual cash flows of insurance contracts should be consistent with the definition and clarifications for acquisition costs in Update 2010-26The staff believe that Alternative 2 is consistent with Update 2010-26, that is, for contracts issued, include direct and incremental costs at the portfolio level that relate to sales force contract selling, underwriting, medical and inspection and policy issuance and processing, in the contractual cash flows. The staff recommend that the details from Update 2010-26 be included as implementation guidance.

Alternative 4—Acquisition costs included in the contractual cash flows of insurance contracts should be limited to those that are not only direct and incremental, but also, recoverable

39. The staff agree with the boards' previous decision that value is created upon the sale of a contract and that contracts are priced to recover acquisition costs through future profits. Future profits would be captured in the margin (residual or composite) and cannot be negative. Therefore, only recoverable acquisition costs would be included. Should a policy lapse, there is typically "clawback" provisions on commissions paid to agents and premium taxes, although recoverability of those would need to be determined at such a time. Other direct and incremental costs, such as salaries paid to

underwriters cannot be directly recouped upon a lapse. However, that would be considered in the overall estimate of the expected cash flows.

40. The staff does not believe it is necessary to specifically state that the costs must be recoverable as it is implicit in the model.

Implementation guidance

41. There is current diversity in practice regarding the types of acquisition costs that insurers defer, especially as it relates to operating costs of an insurance entity that can be allocated to various functions. Based on this current diversity in practice and comments received in the formal comment letter process and during the staff outreach, the staff recommends that implementation guidance should be included to clarify the types of acquisition costs that would be included in the cash flows used to measure an insurance contract.

42. The staff recommend that the level of details be consistent with other implementation guidance being proposed, such as in the leases project, and include the following:

(a) Incremental direct costs of contract acquisition that may be include in the cash flows include:

(i) An agent or broker commission or bonus for successful contract acquisition or acquisitions.

(ii) Medical and inspection fees for successful contract acquisition or acquisitions.

(iii) Payroll-related fringe benefits for employees in that perform sales force contract selling, underwriting, medical and inspection, and policy issuance and processing functions.

(iv) Other costs related directly to an insurer’s acquisition activities that would not have been incurred by the insurer had the acquisition contract transaction(s) not occurred, including reimbursement for travel related activities.

(b) Costs for software dedicated to contract acquisition are not eligible to be included in cash flows. Such costs are not other costs related to those activities that would not have been incurred but for that contract under the definition of that term.

(c) Other costs, some of which entities may consider acquisition-related costs that should be expensed as incurred include:

   (i) Soliciting potential customers

   (ii) Market research

   (iii) Training

   (iv) Administration

   (v) Unsuccessful acquisition or renewal efforts

   (vi) Product development.

43. An insurance entity also would expense as incurred any indirect costs. Such costs include all of the following:

(a) Administrative costs

(b) Rent

(c) Depreciation

(d) Occupancy costs

(e) Equipment costs (including data processing equipment dedicated to acquiring insurance contracts)

(f) Other general overhead.

Question for the boards
Do the boards agree with the staff recommendation that: a) For contracts issued, some acquisition costs should be included in the initial measurement of insurance contracts as contractual cash flows and all other acquisition costs should be expensed as incurred?

b) The acquisition costs included in the cash flows of insurance contracts should be limited to those that are direct and incremental at the portfolio level for the sales force contract selling, underwriting, medical and inspection, and policy issuance and processing functions?

c) Implementation guidance should be provided to clarify the types of acquisition costs that would be included in the cash flows of insurance contracts?

Other considerations

Applicability to the modified approach

44. To maintain consistency between the modified approach and the building block approach, the boards proposed that the preclaims obligation at initial recognition be reduced by the incremental acquisition costs. Although acquisition costs would reduce the preclaims obligation, paragraph 75 of the ED proposes that an insurer disaggregate in the statement of comprehensive income or in the notes the amortisation of incremental acquisition costs and premium revenue, determined as the gross release of the pre-claims obligation, grossed-up for the amortisation of incremental acquisition costs.

45. Some respondents agreed the preclaims obligation should be reduced by the acquisition costs upon initial recognition of an insurance contract. Those respondents believe an insurer’s remaining obligation should not include the portion of the premium that paid for the acquisition costs. The respondents that disagreed believe the financial information provided by insurers would be more decision-useful if acquisition costs are presented separately as an asset because including those costs in the measurement of the liability would impair the presentation of premiums, which, as a primary performance metric, could impede comparability across the nonlife insurance industry.

Option to expense

46. A few respondents suggested that insurers be permitted to expense certain acquisition costs as incurred (even though such costs could be included in the measurement of an insurance contract), rather than including those costs in the expected cash flows. For insurers that write certain lines of business the majority of their acquisition costs are comprised of commissions and premium taxes and the policy period may be short (6 to 12 months). The costs, specifically system costs, to determine the expenses related to other acquisition related activities that would meet the criteria to be included in the cash flows, such as underwriting and policy issuance, does not exceed the benefit they would obtain.

Presentation

47. A few respondents suggested that acquisition costs be presented separately instead of netting those costs against the expected cash flows. Though the staff is not asking the boards to make any decisions on presentation at this meeting, the staff request that the boards consider the implications for presentation in the statement of comprehensive income of including acquisition costs in the cash flows used to measure insurance contracts (in the building block approach). Presentation will be brought to the boards in a future meeting.

48. The staff is not asking the boards to make any decisions on the modified approach at this meeting, but the staff requests that the boards consider the implications of including acquisition costs in the cash flows used to measure insurance contracts for the modified approach (that is, whether to reduce the preclaims obligation by the acquisition costs that would be included in the contractual cash flows under the building block approach). The modified approach will be brought to the boards in a future meeting.

Appendix A – Decisions relating to acquisition costs in other projects

Revenue recognition

1. The exposure draft *Revenue from Contracts with Customers* proposed that all costs incurred in obtaining a contract should be expensed as incurred because the asset resulting from the costs of obtaining a contract is primarily the contract asset. The boards did not believe an entity should recognize a contract asset only as a result of satisfying a performance obligation.

2. The boards are redeliberating issues related to acquisition costs for the revenue recognition project in February. The staff recommendation for that project is to recognize as an asset the incremental costs directly attributable to obtaining a contract that are expected to be recovered. Incremental costs would be those that would not have been incurred if the contract had not been obtained. That recommendation is similar to the proposals in the insurance project in the ED and DP because incremental costs at the contract level would not be expensed as incurred, but included in the cash flows of an insurance contract.

Leases

3. In the exposure draft *Leases*, initial direct costs are capitalized as part of the right-of-use asset (lessee) or the right to receive lease payments (lessor). Initial direct costs are defined as follows:

> Recoverable costs that are directly attributable to negotiating and arranging a lease that would not have been incurred had the lease transaction not been made.

4. The implementation guidance states that initial direct costs may include:

   (a) Commissions

   (b) Legal fees

   (c) Evaluation of the prospective lessee's financial condition

(d) Evaluating and recording guarantees, collateral and other security arrangements

(e) Negotiating lease terms

(f) Preparing and processing lease documents

(g) Closing the transaction

(h) Other costs that are incremental and directly attributable to negotiating and arranging the lease.

5. The implementation guidance also states that the following are not initial direct costs:

   (a) General overheads, such as rent, depreciation, occupancy and equipment costs, unsuccessful origination efforts and idle time.

   (b) Costs related to activities performed by the lessor for advertising, soliciting potential lessees, servicing existing leases or other ancillary activities.

Financial instruments

6. The IASB's exposure draft *Amortised Cost and Impairment* would require deferral of all *transaction costs*, which are defined as follows:

> Incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or financial liability. An incremental cost is one that would not have been incurred if the entity had not acquired, issued or disposed of the financial instrument.

7. The FASB's exposure draft *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* would require deferral of *direct loan origination costs* (net of loan origination fees), which are defined as follows:

> Direct loan origination costs represent costs associated with successfully originating a loan. Direct loan origination costs of a completed loan shall include only the following:

(a) Incremental direct costs of loan origination incurred in transactions with independent third parties for that loan

(b) Certain costs directly related to specified activities performed by the lender for that loan. Those activities include all of the following:

  (i) Evaluating the prospective borrower's financial condition

  (ii) Evaluating and recording guarantees, collateral, and other security arrangements

  (iii) Negotiating loan terms

  (iv) Preparing and processing loan documents

  (v) Closing the transaction.

The costs directly related to those activities would include only that portion of the employees' total compensation and payroll-related fringe benefits directly related to time spent performing those activities for that loan and other costs related to those activities that would not have been incurred but for that loan. See Section 310-20-55 for examples of items.

8. Paragraph 310-20-55-11, as proposed, provides examples of other direct loan origination costs that may be deferred, which include:

   (a) Reimbursement of costs for air travel, hotel accommodations, automobile mileage, a similar costs incurred by personnel relating to the specified activities

   (b) Costs of itemized long-distance telephone calls related to loan underwriting

   (c) Reimbursement for mileage and tolls to personnel involved in on-site reviews of collateral before the loan is granted

9. Paragraph 310-20-55-12, as proposed, provides examples of payroll related fringe benefits that may be deferred, which include:

   (a) Payroll taxes

   (b) Dental and medical insurance

   (c) Group life insurance

   (d) Retirement plans

(e) 401(k) plans

(f) Stock compensation plans, such as stock options and stock appreciation rights

(g) Overtime meal allowances.

10. Paragraph 310-20-55-13, as proposed, provides further guidance on executive compensation that may be deferred. It states that the amount of executive compensation allocable to time spent by members of a loan approval committee is a component of direct loan origination costs.

11. Paragraph 310-20-55-15, as proposed, provides further examples of specified activities contemplated as direct loan origination costs as follows:

(a) Loan counselling, such as discussing alternative borrowing arrangements with borrowers, and negotiating terms

(b) Application processing

(c) Appraisal

(d) Initial credit analysis

(e) Initial credit investigation

(f) Quality control review performed during the underwriting period

(g) Direct approval processing

(h) Loan evaluation and approval committees (all activities involved in origination decisions)

(i) Loan closing.

Appendix B – Recent FASB guidance in Update 2010-26 issued for acquisition costs of insurance contracts

1. Update 2010-26 provides further guidance on the incremental direct costs of contract acquisition that may be deferred:

   (a) An agent or broker commission or bonus for successful contract acquisition or acquisitions.

   (b) Medical and inspection fees for successful contract acquisition or acquisitions.

2. Update 2010-26 clarifies that payroll-related fringe benefits include any costs incurred for employees as part of the total compensation and benefits program. Examples of such benefits include all of the following:

   (a) Payroll taxes

   (b) Dental and medical insurance

   (c) Group life insurance

   (d) Retirement plans

   (e) 401(k) plans

   (f) Stock compensation plans, such as stock options and stock appreciation rights

   (g) Overtime meal allowances.

3. In addition, Update 2010-26 provides examples of other costs related directly to an insurer's acquisition activities that would not have been incurred by the insurer had the acquisition contract transaction(s) not occurred, including all of the following:

   (a) Reimbursement of costs for air travel, hotel accommodations, automobile mileage, and similar costs incurred by personnel relating to the specified activities

   (b) Costs of itemized long-distance telephone calls related to contract underwriting

   (c) Reimbursement for mileage and tolls to personnel involved in on-site reviews of individuals before the contract is executed.

4. Update 2010-26 clarifies that costs for software dedicated to contract acquisition are not eligible to be included in deferred acquisition. Such costs are not other costs related to those activities that would not have been incurred but for that contract under the definition of that term.

5. Update 2010-26 requires that an insurance entity shall expense as incurred any acquisition-related cost that cannot be capitalized in accordance with that Update. Such costs include costs of all of the following:

   (a) Soliciting potential customers (except direct-response advertising capitalized in accordance with paragraph 944-30-25-1A(d))

   (b) Market research

   (c) Training

   (d) Administration

   (e) Unsuccessful acquisition or renewal efforts (except direct-response advertising capitalized in accordance with paragraph 944-30-25-1A(d))

   (f) Product development.

6. In addition, Update 2010-26 clarifies that an insurance entity shall expense as incurred any indirect costs. Such costs include all of the following:

   (a) Administrative costs

   (b) Rent

   (c) Depreciation

   (d) Occupancy costs

   (e) Equipment costs (including data processing equipment dedicated to acquiring insurance contracts)

   (f) Other general overhead.

7. Finally, Update 2010-26 allows an entity to elect not to capitalize costs that the entity had not previously capitalized (if initial application of the amendments in that Update would result in the capitalization of acquisition costs that had not been previously capitalized).