Staff Paper

Project	**Insurance Contracts**
Topic	**Cross cutting considerations on acquisition costs**

Purpose of this paper

1. The boards discussed acquisition costs as part of the insurance contracts project at their meetings on 2 February 2011 and 2 March 2011. Agenda Paper 3E/70E includes the tentative decisions reached at those meetings as well as the basis for those tentative decisions.

2. Acquisition costs is a topic in the revenue recognition, leases, and insurance contracts projects. All three projects incorporate acquisition costs, whether via capitalizing the costs as an asset or including the costs in the measurement of the liability, however, the specific criteria differ. In addition, acquisition costs (transaction costs) are discussed in the current financial instruments standards.

3. This paper provides a comparison of the tentative decisions reached in each of the three projects as well as the current financial instruments standards regarding the specific criteria for incorporating acquisition costs into the various models, the unit of measurement for which it is determined, and how it is presented in the financial statements and recognised in the statement of comprehensive income.

4. This paper also compares the activities of an insurer in acquiring new or renewal business to certain costs incurred in fulfilling a contract under the revenue recognition project and the existing inventory standards.

5. This paper provides supplementary information to Agenda paper 3E/70E *Acquisition Costs Revisited*. It compares the tentative decisions on acquisition costs reached in the projects on revenue recognition, leases, and insurance contracts. It also compares the activities of an insurer in acquiring new or renewal business to costs incurred in fulfilling a contract under the revenue recognition project and the existing inventory standards. This paper does not seek decisions from the boards.

Staff Analysis

Tentative decisions on the treatment of acquisition costs

6. Below is a table comparing the tentative decisions reached on the treatment of acquisition costs in the insurance contracts, revenue recognition and leases projects as well as the current guidance for acquisition costs for financial instruments.

		Insurance Tentative Decisions		Tentative Decisions on Other Projects		Financial Instruments	
		FASB	**IASB**	**Rev Rec**	**Leases**	**FASB**[i]	**IASB**[ii]
Unit of measurement							
	• Contract			X	X	X	X
	• Portfolio	X	X				
Presentation							
	• Asset			X	X	X	X
	• Liability[iii]	X	X				
Costs							
1a	Direct costs of contract acquisition/origination	X	X		X	X	
1b	Incremental costs of contract acquisition/origination			X[iv]			X
2	Portion of employee's total compensation and payroll-related fringe benefits related directly to time spent performing any of the following activities for contracts that have been acquired/originated:						
	(a) Underwriting	X	X				
	(b) Policy issuance and processing	X	X				
	(c) Medical and inspection	X	X				
	(d) Sales force contract selling	X	X				
	(e) Evaluation of the prospective lessee's or borrower's financial condition				X	X	
	(f) Evaluating and recording guarantees, collateral and other security arrangements				X	X	
	(g) Negotiating lease/loan terms				X	X	
	(h) Preparing and processing lease/loan documents				X	X	
	(i) Closing the transaction				X	X	
3	Other costs directly related to the activities in (2) for contracts that have been acquired/originated	X	X		X	X	
4	Direct response advertising	X	X				
5	Costs in (2) and (3) for contracts that have not been acquired/originated		X				
6	Other costs related to acquiring contracts that are not directly related to the activities specified in (3), for example:						
	(a) Software dedicated to contract acquisition		X				
	(b) Equipment maintenance and depreciation		X				
	(c) Agent and sales staff recruiting and training		X				
	(d) Administration		X				
	(e) Rent/occupancy		X				
	(f) Utilities		X				
	(g) Other general overhead		X				
	(h) Advertising		X				

[i] The FASB has not yet made decisions on the costs of obtaining a financial instrument. Therefore, this column represents the staff's recommendation for the treatment of those costs, which is consistent with the current treatment of those costs under Subtopic 310-20 (formerly FAS 91).

[ii] Under IFRSs, a financial instrument that is not subsequently measured at fair value through profit or loss is initially measured at fair value plus or minus incremental transaction costs that are directly attributable to the acquisition, issue, or disposal of the financial instrument. An incremental cost is one that would not have been incurred if the entity had not acquired, issued, or disposed of the financial instrument.

[iii] Included as part of expected cash flows which reduces the residual/composite margin. For example, an insurance contract that has premium of CU 1,200, an expected cash out flow for benefits/claims and related expenses of CU 800 and for acquisition costs of CU200 results in a residual/composite margin of CU 200.

[iv] Under the boards' tentative decisions in the revenue recognition project, an entity should recognize an asset for the incremental costs of obtaining a contract that the entity expects to recover. Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained. An entity should include fulfillment costs that are incurred before the contract is obtained if those costs relate specifically to an anticipated contract and otherwise meet the criteria to recognize an asset in paragraph 57 of the Exposure Draft. As a practical expedient, an entity is permitted to recognize the incremental costs of obtaining a contract as an expense when incurred for contracts with a duration of one year or less.

7. Based on the analysis in the table above, the tentative decision for insurance contracts differs from the other projects. Specifically:

   a. Unit of measurement: The primary reasons supporting the boards' decision to move to determining acquisition costs to be included in the present value of fulfillment cash flows at the portfolio level included:

      i. All other measurements in the model are at the portfolio level, which is consistent with how insurers price and manage their business;

      ii. To eliminate differences among insurers who have different distribution systems (i.e., whether the entity performs contract acquisition services in-house and incurs internal agent commission and or salaries or sources services externally and pays commissions to third-party agents or uses direct response advertising and incurs related costs);

      iii. To include costs that are not linked to a specific contract such as underwriting, medical and inspection and policy issuance, that could be significant.

   b. Presentation: The boards tentatively decided that an insurers costs to acquire new or renewal business is part of the contract cash flows and should be included in the expected cash outflows used in measuring the liability.

   c. Types of costs:

i. Incremental costs: An incremental cost is one that would not have been incurred if the entity had not acquired, issued, or disposed of the contract or financial instrument. The most common cost for insurance companies that would meet this criteria are commissions paid to an agent. The boards' tentative decisions regarding incremental costs of contract acquisition/origination is consistent across the projects.

ii. Costs directly attributable to the acquisition activity of a contract. The boards' tentative decisions regarding direct costs of contract acquisition/origination, portion of employee's total compensation and payroll-related fringe benefits related directly to time spent performing acquisition activities for contracts that have been acquired/originated is consistent with the boards tentative decisions in the leases project and the FASB's financial instruments project. The IASB tentatively decided that all costs that are directly attributable to acquisition activity, including indirect costs, that can be allocated to acquiring the portfolio should be included.

d. Costs incurred (or to be incurred) or only costs for those contracts sold: The FASB's tentative decision to limit the acquisition costs to be included in the contract cash flows to those related to successful contracts only is consistent with the boards tentative decisions on the other projects where the costs directly attributable to only contracts sold are deferred.

8. A discussion of the basis for the boards' respective tentative decisions is included in Agenda Paper 3E/70E.

Lessons learned from current practice

9. The IASB's tentative decisions could be interpreted as being consistent with current accounting for acquisition costs in many jurisdictions, including the US. Current US GAAP Guidance defines acquisition costs as "...those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Commissions and other costs (for example, salaries of certain employees involved in the underwriting and policy issue functions, and medical and inspection fees) that are primarily related to insurance contracts issued or renewed during the period in which the costs are incurred shall be considered acquisition costs."

10. Any given cost can be classified according to its variability with some measure of activity. Determination of the variability of a given cost is frequently a difficult problem. Commissions are generally fully variable with premiums - no premiums, no commissions. Underwriting expenses are usually semi-variable. The president's salary is usually fixed. All costs are variable when viewed from the perspective of a company's entire lifetime. Furthermore, elimination of a given activity would also eliminate most or all of the costs associated with the activity.

11. This ignores the concept of the “relevant range” of activity, which may be broadly defined as the range of activity within which operations are most likely to fall under reasonable operating conditions. Viewed another way, the chance that operations will fall out-side the relevant range is so remote that cost behavior applicable to operations outside the relevant range could be disregarded.

12. There are six general types of relationships between costs and volume, progressing from the most variable to the least variable. Insurers have used these relationships to assist them in determining which costs are deferrable as acquisition costs under current guidance.

    a. Perfectly linear relationships - in those cases in which a cost item varies directly with production, there is no question that it is variable.

    b. Essentially linear relationships - a cost may stray more or less randomly from the curve of production while retaining a tendency to adhere to the curve. Such fluctuations are neither extreme nor of long duration. In that case, the cost may be regarded as bearing an essentially linear relationship to production.

    c. Step-cost relationships - sometimes a given outlay will cover a range of production. Above the range another outlay is required and, when the range of production associated with the second outlay is exceeded, still another outlay is required, and so on. These circumstances would indicate a step-cost relationship. One characteristic of a step-cost relationship is an unavoidable period of under-utilization of capacity until the top of the range is reached. Nevertheless, the central tendency of the cost curve is to follow the curve of production.

    d. Semi-variable relationships - when a cost departs significantly from the curve of production but moves grudgingly in the same direction, it may be regarded as semi-variable. It would not be unusual for the cost curve and the production curve to cross at some point. The principal difference between a semi-variable and a semi-fixed relationship is the frequency with which the level of cost changes relative to the level of production.

    e. Semi-fixed relationships - when a cost changes very infrequently in relation to the curve of production, it may be regarded as semi-fixed.

    f. Fixed relationships - And finally, when a cost is completely unresponsive to the level of production, it may be regarded as fixed.

13. In practice, costs which bear a perfectly linear or essentially linear relationship to production qualify under the variability criterion. Step-cost relationships also qualify, as a general rule, so long as the range of production covered by the cost is not unreasonably wide. Semi-variable costs would rarely qualify under the criterion, unless the attribution criteria are satisfied in so positive and convincing a manner that one is forced to conclude

that the cost under consideration is an acquisition cost. In that case the variability criterion would be stretched to the limit to accommodate common-sense. Semi-fixed and fixed costs should never qualify under any reasonable concept of variability.

14. Appendix A includes an analysis of typical costs in the insurance production process and considerations for whether those costs are deferrable under current guidance. A line must be drawn between selling and administrative expenses that 1) are directly attributable, and hence may be deemed to "attach" to the insurance product and 2) are fundamentally no different than the selling and administrative expenses of any other kind of business, and should be expensed in the period incurred. This involves judgment and hence there is diversity in practice.

    a. Is a field manager's salary a direct cost or an indirect cost? While not a direct cost of the contract it could be considered a direct cost of a portfolio. Field clerical and related expenses should be analyzed into the same elements as office expense allowances paid to general agents, and only the portion associated with the direct production function should be deferred as acquisition costs, assuming, of course, that the variability test is satisfied.

    b. A question arises regarding the space occupied by the field manager. Is the office a direct expense and how much of it is direct vs. indirect?

    c. Conventions - The cost of an agent's convention can sometimes be regarded as a deferrable acquisition cost. That is because agents usually must meet production quotas to qualify to attend such conventions; hence they are in the nature of production bonuses. However, some may consider conventions as training sessions and recruiting seminars which would not be deferrable.

    d. Recruitment and training are designed to bring an agent up to the point at which they can sell effectively for the company. Many would say training is therefore a development cost. However, others include training in the deferrable acquisition costs as agents (and employees) need to understand the products to be able to sell the products.

    e. Sales and marketing costs is either an administrative cost or a development cost, depending in part on the nature of the research and in part on one's point of view. In either case, the costs associated with market research activity would not be deferrable as acquisition costs. Although, some companies have included these types of costs as part of the deferrable acquisition costs.

    f. Advertising costs should be expensed in most cases unless they can be specifically attached to a contract sale. However, many companies treat a portion of their advertising costs as deferrable acquisition costs.

g. Commission processing also would be considered administrative and not directly related to production. Although the amount of the commission may fluctuate the processing of commission checks would rarely change. However, some have viewed commission processing as deferrable acquisition costs since the agents/employees need to get paid for the new business generated.

h. Some believe that if a given cost varies with production it is automatically a direct cost. However, that is not necessarily the case. The data processing charge to the issue department is a good example of a variable cost that is not direct. Data processing will usually base its charges on work performed; thus the charge to the issue department will always vary with production. But the costs of the data processing department itself will not vary much. It is an ongoing operation with heavy fixed costs which themselves will not vary with production.

i. If a specific cost was deemed to be one that met the criteria to be deferred, companies typically deferred all the costs associated with that activity, or the portion determined to be part of the acquisition activity, without regard to whether the costs clearly "attached" to a product having future utility. Therefore there was no determination of which costs were incurred for (or attached to) successful contracts.

15. Based on the above analysis (and that in Appendix A) the broader the eligibility for acquisition costs, the more allocations and therefore the increased judgment that management has to make in order to determine which costs qualify to be included as acquisition costs. Those judgements have lead to less comparability from company to company and what some view as excessive deferrals of costs as acquisition related.

Tentative decisions on the treatment of inventory and pre-acquisition costs for construction and service contracts

16. While "acquisition costs" is what the industry has referred to as the process of acquiring new or renewal business, the process of "acquiring" a new or renewal insurance contract includes customizing or producing an insurance contract for the needs of the potential policyholder. Although the "production/manufacturing" of the insurance contract is not generating a separate resource it does incorporate the identification of a potential policyholder and customizing the contract such that the policyholder will purchase the insurance contract. The underwriting of a policy, including medical inspections and other research, are all part of customizing the product. For example, the underwriting of a life insurance policy is based on an individual's current age and sex as well as their health condition and life style and the coverage they need for beneficiaries or to cover their existing debt. The underwriting of automobile insurance is based on the type of car, the age and sex of the individual, their driving history and their primary geography. An insurers process to "acquire" an insurance contract could be analogized to a manufacturing company producing inventory or a service organization developing a product for a specific customer.

a. ASC Topic 330-30-1 states, “The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. It is understood to mean acquisition and production cost, and its determination involves many considerations.”

b. IAS 2, Inventory, paragraph 10 states, “The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

c. The boards tentatively decided in the revenue recognition project: “If the costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with another Topic (for example, Topic 330 on inventory, Topic 360 on property, plant, and equipment, or Topic 985 on software), an entity shall recognize an asset only if those costs:

    i. relate directly to a contract (or a specific anticipated contract under negotiation);
    ii. generate or enhance resources of the entity that will be used in satisfying performance obligations in the future (that is, the costs relate to future performance); and
    iii. are expected to be recovered.

17. The table below identifies the costs that are capitalized for inventory and construction contracts under current US GAAP and IFRSs as well as the boards’ tentative decisions on costs/resources that would be capitalized as fulfillment costs in the revenue recognition project because they are not recognized under other Topics or other IFRSs.

	Inventory		Construction		Revenue Recognition
	U.S. GAAP: Topic 330	IFRS: IAS 2	U.S. GAAP: Subtopic 910-20 and Subtopic 605-35	IFRS: IAS 11	Tentative Decisions
Measurement basis	Cost	Cost	Contract costs	Contract costs	Fulfillment costs
Principle	Inventory should be measured as the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location.	Inventory should be measured as the costs of purchase, costs of conversion, and other costs incurred in bringing the inventory to its present location and condition.	Subtopic 910-20: Operating unit costs for construction equipment may be included in contract cost using the use rate theory. Subtopic 605-35: Contract costs generally include all direct costs and indirect costs identifiable with or allocable to the contract. Costs should be considered period costs if they cannot be clearly related to production.	Contract costs include (1) costs that relate directly to the specific contract; (2) costs that are attributable to contract activity in general and can be allocated to the contract; and (3) such other costs as are specifically chargeable to the customer under the terms of the contract.	If the costs incurred in fulfilling a contract do not give rise to an asset eligible for recognition in accordance with another Topic or other IFRSs, an entity should recognize an asset for those costs that: (1) relate directly to a contract (or a specific contract under negotiation); (2) generate or enhance resources of the entity that will be used in satisfying performance obligations in the future (that is, the costs relate to future performance); and (3) are expected to be recovered.

	Inventory		**Construction**		**Revenue Recognition**
Costs included?	**U.S. GAAP: Topic 330**	**IFRS: IAS 2**	**U.S. GAAP: Subtopic 910-20 and Subtopic 605-35**	**IFRS: IAS 11**	**Tentative Decisions**
Direct materials and direct labor	Yes	Yes	Yes	Yes	Yes
Variable overhead costs	Yes; allocated to each unit of production on the basis of the actual use of the production facilities	Yes; allocated to each unit of production on the basis of the actual use of the production facilities	Yes; allocated to specific contracts if they relate to those contracts	Yes; allocated to specific contracts if they relate to those contracts	Yes; if meets criteria (1), (2), and (3) in the principle
Fixed overhead costs	Yes; allocated based on the normal capacity of the production facilities	Yes; allocated based on the normal capacity of the production facilities	Yes; allocated to specific contracts if they relate to those contracts or may be allocated if clearly related to production	Yes; allocated to specific contracts based on the normal level of construction activity	Yes; if meets criteria (1), (2), and (3) in the principle
General and administrative costs	No; recognized as an expense in the period incurred (except for the portion, if any, clearly related to production)	No; recognized as an expense in the period incurred (except for the amount, if any, that contribute to bringing inventories to their present location and condition)	No; recognized as an expense in the period incurred (except if the completed-contract method of accounting is used)	No; recognized as an expense in the period incurred (except if reimbursement of those costs is specified in the terms of the contract)	No; recognized as an expense in the period incurred (except if reimbursement of those costs is specified in the terms of the contract or the entity would not have incurred those costs had the contract not been obtained)

	Inventory		Construction		Revenue Recognition
Costs included?	**U.S. GAAP: Topic 330**	**IFRS: IAS 2**	**U.S. GAAP: Subtopic 910-20 and Subtopic 605-35**	**IFRS: IAS 11**	**Tentative Decisions**
Abnormal freight, handling costs, and wasted materials (spoilage)	No; recognized as an expense in the period incurred	No; recognized as an expense in the period incurred	Not specified	Not specified	No; recognized as an expense in the period incurred
Unallocated overhead costs	No; recognized as an expense in the period incurred	No; recognized as an expense in the period incurred	No; recognized as an expense in the period incurred	No; recognized as an expense in the period incurred	No; recognized as an expense in the period incurred
Selling costs	No; recognized as an expense in the period incurred (unless capitalized in accordance with another Topic)	No; recognized as an expense in the period incurred (unless capitalized in accordance with other IFRSs)	No; recognized as an expense in the period incurred (unless capitalized in accordance with another Topic)	No; recognized as an expense in the period incurred (unless capitalized in accordance with other IFRSs)	No; recognized as an expense in the period incurred (unless the cost is an incremental cost of obtaining the contract or the cost is capitalized in accordance with another Topic or other IFRSs)

18. The table above demonstrates that the IASB's tentative decision on the types of costs to include in the measurement of the expected cash outflows is more consistent with the costs that would be capitalized under IFRSs and US GAAP for inventory, construction contracts, and the tentative decisions reached in the revenue recognition project.

19. However, under existing inventory and construction contracts guidance and the boards' tentative decisions in the revenue recognition project, costs capitalized should be based on the probable recoverability and any costs previously capitalized are expensed when it is determined that the inventory or service contract will not be sold.

    a. ASC Topic 330-35-2: "… in accounting for inventories, a loss shall be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes. The measurement of such losses shall be accomplished by applying the rule of pricing inventories at the lower of cost or market." Paragraph 35-8 states: "Depending on the character and composition of the inventory, the rule of lower of cost or market may properly be applied either directly to each item or to the total of the inventory (or, in some cases, to the total of the components of each major category)"

    b. IAS 2, paragraph 28 states: "The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased. The practice of writing inventories down below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use. Inventories are usually written down to net realisable value item by item. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line."

    c. ASC Topic 605-35-25-41-a states, "Costs that are incurred for a specific anticipated contract and that will result in no future benefits unless the contract is obtained shall not be included in contract costs or inventory before the receipt of the contract. However, such costs otherwise may be deferred, subject to evaluation of their probable recoverability, but only if the costs can be directly associated with a specific anticipated contract and if their recoverability from that contract is probable."

d. IAS 11, Construction Contracts states: "Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract."

e. The boards tentatively decided in the revenue recognition project that "An entity shall recognize an impairment loss to the extent that the carrying amount of an asset recognized in accordance with paragraph ... exceeds the amount of consideration to which an entity expects to be entitled in exchange for the goods or services to which the asset relates, less the remaining costs that relate directly to providing those goods or services (as described in paragraph 60). To determine the amount to which an entity expects to be entitled, an entity should use the principles for determining the transaction price." The FASB board also tentatively decided that reversals of previous impairments are prohibited.

20. If the boards were to consider acquisition costs of an insurance contract as being comprised of both "acquisition costs" and "production costs", they would need to determine whether to include only those costs for successful contracts which would be consistent with other projects or whether to modify this criteria and include all costs.

Summary

21. The result of considering acquisition costs of an insurance contract as being comprised of both "acquisition costs" and "production/fulfillment costs" would have the following impact on the boards' tentative decisions:

a. FASB: increase the types of costs included

b. IASB: decrease the costs included to only those on successful contracts and potentially the type of costs.

c. IASB and FASB: converged accounting for acquisition costs.

22. By leaving the guidance too broad, companies could include costs in excess of what the boards intended as indicated in the lessons learned section above. To alleviate that concern the boards could specify the acquisition type functions thereby limiting the expenses directly related to those functions. This would expand the costs included in the FASB's tentative decision and limit the costs included in the IASB's tentative decision.

23. This would alleviate some concern by respondents that have questioned the rationale of the FASB board in allowing the compensation costs for certain functions to be included in the measurement of the expected cash outflows but not the other costs related to the personnel in those functions performing their job, such as certain allocated costs for items such as the space occupied and utilities used.

24. In addition, some respondents have raised the concern that the expenses paid to a third party such as commissions paid to an independent agent, includes a reimbursement for

costs incurred by the third party which would not be included in the measurement of the expected cash outflows if the same function was performed by a captive agency or in-house. This would result in consistent treatment of costs and activities whether internal or third party costs.

25. Successful contracts would be considered obsolete and would need to be expensed. This would be consistent with how acquisition costs related to unsuccessful contracts are handled in the revenue recognition and leases project.

Appendix A – Insurance Production Process

1. The insurance production process includes selling, selection, and issue activities and indirect costs relating to these items. Determining what costs are clearly associated with selling, selection and issue activities is not always easy. Regardless of available tests, guidelines and precedents, some degree of subjectivity will almost always be involved in deciding on what costs are properly associated with production activities. The items listed below are general guidelines used today in the types of acquisition costs that are deferred, however, there is wide diversity in current practice.

Analysis of typical costs

2. Sales compensation and allowances: Types of sales organizations and methods of compensating agents vary widely in the insurance industry to the point where the number of possible combinations of organization and compensation methods is virtually without limit. Thus one finds managing general agents; personal-producing general agents; branch managers; brokers; and commissions, salaries, bonuses and allowances of every description. Therefore, it is necessary to think in terms of commissions and commission equivalents. Commissions and commission equivalents that relate to identifiable units of production qualify for deferral as acquisition costs under current practice.

    a. Commissions paid to agents who actually write the business clearly vary with and are primarily related to the production of new business. First year commission to a selling agent, sub-agent, or broker based on their production would normally qualify for deferral as an acquisition cost. Production bonuses that are based on defined levels of production and certain commissions paid to producers in subsequent years would generally also qualify for deferral.
    b. Some insurance companies employ salaried agents. Other companies combine salaries and commissions, or establish a floor on commissions which effectively constitutes a salary. In these situations it is important to distinguish between agent financing and compensation for production. Financing is a development cost that generally does not qualify for deferral as an acquisition cost. When financing is a significant element in agents' compensation, the financing payments should be split between compensation for production and development costs. One way to make the split would be to allocate an amount based on the normal commission rate to acquisition costs and the balance to development costs. When an agent is compensated entirely by salary, the compensation would

tend to follow a step-cost pattern in relation to production. That is because one agent can handle only so much new business; when that limit is reached, another agent must be added. However, salaries to agents during their training period, prior to the time that they are fully prepared to sell new business, should be regarded as financing or development costs.

c. General agents often receive several different types of commissions. Personal-producing general agents receive writing agent's commissions on business produced by them, similar to commissions to selling agents. In addition, general agents normally receive overrides for the achievements of the sub-agents. Such overrides are also typically deferred under current accounting. Finally, a general agent typically receives production bonuses based on defined production quotas for their entire agency. Such production bonuses are essentially of the same nature as production bonuses paid to writing agents and also typically qualify for deferral.

d. General agents also receive a myriad of special "allowances"that are sometimes paid in the form of commissions. Such payments might include recruiting and training allowances which should be treated as development costs.

e. Office expense allowances are designed to assist the agent in covering administrative overhead. Only the portion of office expense allowances associated with the direct production function should be deferred as acquisition costs, and then only if it passes the variability tests. Other office expenses attributable to supporting the development function, policy maintenance, and general agency overhead should not be deferrable.

f. The allocation of salaries to branch managers and assistant branch managers should follow the guidelines as those for general agents as well as the allocation of branch office expenses.

g. Renewal commissions are generally deferred acquisition costs based on a descending commission scale even though such expenses are incurred subsequent to issue. Renewal year overrides and persistency bonuses should also be accounted for as a part of acquisition costs.

3. Sales support costs: Commissions and commission equivalents represent a major part of total selling costs, but sales support costs which includes agent financing, agency administration, advertising, sales analyses, agents conventions, etc. also require sizable expenditures. For example, it would not be unusual for sales support to amount to 50 percent of commissions and commission equivalents.

    a. Home office agency administration includes home office senior marketing executives, work on agents' licenses and contracts, processing of agents' complaints, and the like. Generally agency administration costs would fail the test of variability, and such costs would also fail most of the attribution tests. Agency administration is overhead and should be accounted for as such.

b. Field supervisors would be treated the same as agency administration, however, the portion of a field supervisors compensation association with the time devoted to actual supervision of established producing agents may generally be regarded as an acquisition cost if it meets the variability criterion. Costs for field clerical staff could be allocated between acquisition costs and other costs on an appropriate basis.
c. Recruiting is a development cost that would not qualify for deferral as an acquisition costs. Such costs would rarely be associated with the production of a single year. Recruiting costs include the portion of managers' salaries associated with the time spent on recruiting, implicit or explicit recruiting allowances to general agents, travel expenses incurred in recruiting, advertising for agents, the cost of operating a home office recruiting unit, etc.
d. Agent training has the same characteristics as recruiting. It is designed to bring an agent up to the point at which they can sell effectively for the company. It is therefore a development cost that generally is not associated with the production of a given year. The costs of training established agents differs somewhat from the cost of training new agents in that the objective of such training is to make an effective agent more effective, to update or refine their skills, but it is still training, the cost of which is shouldered in the hope that the agent will in fact become more productive in the current and future years. As such, training would normally fail the variability or attribution tests or both.
e. The cost of an agents' convention can sometimes be regarded as a deferrable acquisition cost. That is because agents usually must meet production quotas to qualify to attend such conventions; hence they are in the nature of production bonuses.
f. Product advertising would usually not be deferrable as it is virtually impossible to establish a causal relationship between product advertising and production.
g. Other operating expenses such as rent, postage and telephone are generally deferrable for the portion of such expenses allocable to direct production if it qualifies under the variability test.

4. Selection costs: Costs of underwriting a policy generally vary with production in a step-cost relationship, and such costs typically meet all of the attribution criteria. Selection costs qualifying for deferral would usually include salaries of underwriters involved directly in the underwriting process, salaries of supervisory-level personnel whose responsibility is limited to direct supervision of underwriters, salaries of clerical support of the underwriting function, expenses of medical examinations and inspection reports, MIB fees, and the portion of a medical department's costs that relate to effort devoted solely to underwriting consultation. Costs incurred for printing of underwriting forms, telephone calls by underwriters, etc., would also normally qualify. The salary of the

senior underwriting executive and their assistants should typically not be deferred, nor should any costs associated with medical, statistical, or other research.

5. Policy issuance costs: Costs associated with issuing a policy - policy forms, policy preparation costs, premium calculations, setting up all of the records initially, control and suspense procedures pending delivery, and the cost of delivery itself - are typically deferrable as acquisition costs. This applies to both new business and renewal business.

6. Indirect costs in an insurance company are not clearly distinguishable from direct costs. The general rule is that costs, and particularly costs requiring allocation between new business and other functions, are regarded as indirect costs unless it can be demonstrated that the cost is readily traceable to new business. In determining indirect costs, it is helpful to consider 1) indirect costs incurred within the departments themselves, and 2) costs incurred in other departments that provide services to the operating departments.

   a. Intra-departmental costs that would generally qualify for allocation to new business functions would include the costs of supervision of and direct support for those functions whose costs are assignable to new business as direct costs. This would usually include, for example, such portion of a branch manager's salary as relates to the time they spend on supervision of agents' selling efforts, as well as a pro rata share of the cost of the space they occupy, clerical assistance, and miscellaneous items such as telephone costs. It would generally include the cost of the space occupied by underwriters and issue personnel, clerical assistance rendered to such personnel, and miscellaneous costs such as telephone expense and postage.
   b. Interdepartmental charges that would generally qualify for allocation to new business functions would include reasonable charges, predicated on actual work performed and priced on the basis of normal capacity, of the data processing department, office services (reproduction, mail room, printing, file services, and the like), and the accounting and policyholder service departments (but only to the extent that those departments perform services that could be performed directly by the operating departments).
   c. Sales and marketing costs is either an administrative cost or a development cost, depending in part on the nature of the research and in part on one's point of view. In either case, the costs associated with market research activity would not be deferrable as acquisition costs.

7. Companies defer both first year and renewal commissions whether it be to selling agents, salaried agents, or general agents. Commissions clearly vary with and are related to the production of new business.

8. Agent production bonuses are also deferred if they are based on defined levels of production.

9. Persistency bonuses are treated as non-level commissions and, if material, are accounted for as a part of acquisition costs, first year or renewal depending on when the bonus accrues.

10. And finally, some portion of an agency's office expenses is attributable to supporting the development function; some portion to supporting the direct production function; some portion to policy maintenance; and some portion to general agency overhead. Only the reimbursement allowances relating to the direct production functions should be deferred as acquisition costs, and then only if it passes the variability test.

Relationship between costs and production

11. A cost can properly be regarded as primarily relating to production only to the extent that all five tests listed below are met.

    a. Cost must be logically attributed to production; passes common sense test
    b. Some precedent in industry practice should exist for attributing specific costs to production
    c. Cause-and-effect relationship must exist between cost and production
    d. Relationship must be clearly demonstrable
    e. Relationship must be measurable within the relevant accounting periods

12. These conditions might for convenience be referred to as "tests" of logic, precedence, causality, demonstrability and finitude. These are fairly severe tests, but it is important to apply them in determining whether the relationship between costs and production is sufficient to warrant deferring the costs as acquisition costs.

13. If a cost cannot logically be associated with production - using "logic" as a synonym for common sense - it cannot be deemed to relate primarily to production. For example, audit fees cannot logically be associated with production.

14. Some believe that precedent should govern the treatment of certain types of expenses, such as policy maintenance and general overhead. However, in the case of other business enterprises, such expenses should be charged to operations in the period incurred. For example, the president of a life insurance company may spend a significant portion of his time on the selling function, and his compensation might conceivably vary with production, but there is little precedence for regarding a president's salary as an inventoriable cost. The precedence criterion must be applied with some care.

15. If an expenditure does not result in production, the causality test is not satisfied and the cost cannot properly be regarded as relating to production. The cost need not necessarily precede production to qualify; the true test of causality is whether production at the current level of volume would be impossible if the cost were not incurred. Thus selling, underwriting and issue costs would clearly qualify. Production in a life insurance

company refers to paid-for business placed on the books, and selling, underwriting, and issue are all necessary to get the business on the books.

16. If the relationship between a cost and production is not clearly demonstrable, a relationship cannot be deemed to exist. Expenditures for public relations might be regarded as bearing a causal relationship with the current level of production, but the relationship can rarely, if ever, be demonstrated.

Allocation of costs

17. The “unit cost” of a product is determined by dividing the total costs applicable to the units produced by the number of units produced. In a continuous mass production operation of an insurance company, unit costs are more readily computed using process-costing techniques, under which costs are accumulated by departments. These departmental costs are applied to relatively great number of units which pass through the department. The center of attention is the total department costs for a given time period in relation to the units processed. Accumulated department costs are divided by quantities produced during a given period in order to get unit costs. It is important to appreciate that variability will differ according to the base used to measure production. For example, commissions would usually be perfectly linear with respect to premiums for a given category of products. No one measurement base is supreme. “Units produced” might be expressed in the form of premiums, number of policies, face amount of insurance issued, or “units” of insurance issued. Any one of these bases, or a combination, might be appropriate for purposes of measuring variability.