STAFF PAPER

June 2012

REG IASB Meeting

Project	**Insurance contracts**
Paper topic	Timing of recognition of acquisition cost expense and related premiums

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Purpose of this paper

1. This paper follows up from the Board's discussion of acquisition costs at its May 2012 joint meeting with the FASB. This paper discusses a matter on which the IASB did not conclude: the timing of recognition of the acquisition cost expense and related revenue.

2. This paper supplements agenda papers 2B and 2C, which discuss a method for determining the revenue (earned premiums) presented in the statement of comprehensive income for each reporting period. As in agenda papers 2B and 2C, we do not ask for any decisions.

Background

May 2012 meeting

3. In May 2012, the IASB and FASB jointly discussed the treatment of acquisition costs in the building block approach. The *Update* for that meeting is reproduced in the Appendix.

4. At that meeting, the boards discussed different approaches for the accounting for acquisition costs. The staff identified the questions that the boards would need to answer as follows:

   (a) Should acquisition costs be presented as part of a net contract asset or liability, or as an asset separate from the remaining contract asset or liability?

(b) Should the amount of premium presented in the statement of comprehensive income over the contract term be the full customer consideration, or should that amount be the customer consideration less the acquisition costs?

(c) If the full customer consideration is presented, should the acquisition cost expense and related income be recognized when the acquisition costs are incurred, or over the contract term?

(d) Should the acquisition cost cash flows be disclosed as part of the cash flows or as part of the residual/single margin?

(e) Should the insurer be required to present the liability determined on the basis of the fulfillment cash flows (ie excluding acquisition costs) as a separate line item from the residual/single margin (net of acquisition costs)?

5. At that meeting, the IASB:

(a) tentatively decided that acquisition costs should be included in the cash flows used to measure the insurance contract liability.

(b) indicated that the full customer consideration should be presented as premium in the statement of comprehensive income over the contract term.

(c) did not discuss

(i) presentation of, or disclosures about, acquisition costs;

(ii) the timing of recognition of the acquisition cost expense and related income. The boards noted that that this question needs to be answered in the context of the way in which earned premium is determined for each accounting period.

6. The FASB tentatively decided against an approach that would require an insurer to expense the acquisition costs and recognize income equal to, and offsetting, those costs when the acquisition costs are incurred. The FASB did not decide whether to expense acquisition costs, recognize them as an asset, or whether to recognize a reduction in the margin when the costs are incurred and show them net against the margin and allocated to profit or loss in the same way as the margin. Thus they would either recognise the premium charged to cover acquisition costs as premium over time, or exclude that amount from the premium presented in the statement of comprehensive income. The FASB also indicated a preference for acquisition costs

to be excluded from the cash flows used to measure the insurance contract liability. The FASB did not discuss presentation and disclosure.

User outreach on acquisition costs

7. Users of financial statements analyse the amount of acquisition costs incurred and the deferred acquisition cost asset that is recognised under many existing accounting practices for the following reasons:

   (a) they compare acquisition costs incurred relative to the number of new contracts in-force as an efficiency measure, ie how well the insurer converts dollars spent on acquisition costs into new contracts over time.

   (b) they assess the extent to which the deferred acquisition cost asset that exists in current practice might be written down if the costs are expected to exceed the expected premiums. The size of the deferred acquisition cost asset indicates the size of potential charges to profit and loss in future years.

8. Therefore, users of financial statements are less interested in the amount of acquisition cost expense amortised each period than in the total amount of acquisition costs incurred, relative to the volume of contracts acquired.

Further information

9. Agenda paper 2B/83B for the May 2012 meeting provides further background about the boards' previous discussions about acquisition costs.

Staff analysis

10. The question of the timing of recognition of acquisition cost income and expense is related to the question of when premiums are recognised in the statement of comprehensive income each period. In this paper, we build on the IASB's tentative decision that acquisition costs are included in the cash flows used to measure the insurance contract liability.

Treating acquisition costs in the same way as other cash flows

11. In agenda papers 2B/84B and 2C/84C, we consider three ways for determining how much premium would be recognised in each accounting period. If acquisition costs were treated in the same way as other cash flows, the following implications arise for each of those ways:

    (a) In a 'written premium'[1] approach, the insurer presents as premium the expected present value of all the premiums receivable within the boundary of contracts initially recognised in the period. That amount includes the premium charged to cover acquisition costs. As a result the premium charged to cover acquisition costs would be recognised in the period the contract is written.

    (b) In a 'premium due' approach, premiums are presented as revenue when expected to be receivable (and the corresponding increase in the liability is presented as an expense). As a result:

        (i) the premium charged to cover acquisition costs would be recognised when those premiums are expected to be receivable.

        (ii) If the acquisition cost expense were to be recognised when incurred (consistent with other expenses in the building block approach), this would mean that the expense and related premium would be recognised in different periods. It would be possible to require that the acquisition cost expense is deferred and recognised in the period when the related premium is recognised, but this would mean that the pattern of recognition of acquisition cost expense would be different depending on how the insurer chooses to define how it recovers the expense.

        (iii) Changes in estimates of the cash inflows that are expected to be receivable, including those additional inflows that arise if an insurer makes charges related to the recovery of acquisition costs, would be recognised as an adjustment to premiums in the period the change in estimate occurs. This may increase the amount of premiums recognised, or may result in reversal of premiums previously recognised.

[1] As noted in agenda paper 2B, the Exposure Draft labelled the 'premium due' approach as a 'written premium' approach. However, the term 'written premium' has since been applied to a different premium approach, ie one that measures the present value of the premiums expected to be receivable within the boundary of contracts initially recognised in the period. We therefore use the term 'premium due' throughout this paper to refer to the approach described in the Exposure Draft.

(c) In the earned premium approach discussed in agenda papers 2B/84B and 2C/84C, insurers would present a volume measure for insurance contracts that is similar to the measure of revenue that results from applying the requirements proposed in the draft Revenue standard.[2] That approach allocates revenue by reference to the initial estimates of the pattern of services provided in each period, eg by reference to the expected claims and other benefits in each period as estimated at the time of pricing the contract. This way of allocating revenue reflects a view that the service that the insurer transfers to the customer is insurance coverage and the amount recognised in each period is the amount that the insurer would have charged for each period of coverage if it had issued separate contracts for each period. (The amount charged would also include any amount the insurer would charge for any option that the policyholder has to continue, extend or renew the contract.) Applying that view:

(i) the insurer allocates the revenue when it expects the cash outflows to occur. This means that the insurer would recognise revenue to cover acquisition costs when it expects the acquisition costs to be incurred.

(ii) Changes in estimates of the expected acquisition costs would result in an adjustment to premiums in the period the change in estimate occurs (to the extent that the change in estimate is not offset in the residual margin). This may increase the amount of premiums recognised, or may result in reversal of premiums previously recognised.

[2] Agenda paper 2C/84C also notes that revenue could be recognised each period on the basis of the incurred claims. That way of allocating revenue reflects s view that the service the insurer provides is the payment of claims and that it earns revenue when claims are incurred. Applying that view, if the insurer treats all cash flows in the same way, the insurer would earn revenue when cash outflows are incurred, ie when the acquisition costs are incurred.

Treating acquisition costs in a way that differs from other cash flows

12. The Board could also decide that acquisition cost income and expense should be recognised over the contract term, regardless of the general approach for the other cash flows that are used to measure the insurance contract liability. This view would be consistent with the view that acquisition costs do not give rise to service and so they should be treated differently from the other cash flows.

13. If this were the case, the staff proposes that this income and expense would be recognised over the coverage period in line with the pattern of services under the contract, consistently with the allocation of the residual margin. Thus, an insurer would account for and present the cash flows relating to the recovery of acquisition costs in the same way as the other cash flows that are expected to arise in fulfilling the contract, but defer the recognition of premium equal to, and offsetting, the acquisition costs that are incurred over the coverage period. As with the premiums due approach, the acquisition costs could either be recognised when incurred, or deferred and recognised in the same pattern as the related premium. If the costs were deferred it would also result in similar accounting treatment to that achieved by the recognition

14. This approach could present some operational complexity in tracking the amount of acquisition cost not yet recognised in the statement of comprehensive income.

15. Nonetheless, some believe that acquisition cost income and expense should always be recognised over the contract term for the following reasons:

    (a) Acquisition costs do not relate to the insurer’s performance under the contract because the policyholder receives no separate benefit from the acquisition cost component of the premium and views the value of the insurance contract as only the provision of coverage. Therefore, applying the principles in the revenue recognition model, no revenue should be recognised when acquisition costs are incurred or paid.

    (b) the recognition of the acquisition cost expense over time would lead to consistent results with the current proposals for leases, the current guidance for financial instruments under U.S. GAAP, and for financial instruments held at other than fair value through profit or loss under IFRS. Applying each of these models, qualifying acquisition costs would be recognised as an asset (or included in an asset or liability measurement) on the statement of financial position and subsequently amortised. Agenda paper 2B/83B, Appendix A from the May 2012 meeting provides excerpts from the relevant guidance.

(c) Recognising the acquisition costs and the premiums over the coverage period would be consistent with the view that a long-duration insurance contract comprises a series of one-year term contracts, and therefore, the upfront acquisition costs should be recognised in each of those one-year terms.

16. However, the staff notes that the basis for the model developed by the boards is that it treats all the cash flows that are expected to arise as the insurer fulfils the insurance contract liability in the same way, regardless of the reason that those cash flows occur or on the basis of who the counterparty is. This captures any interdependencies between those cash flows and other cash flows arising from the insurance contract and avoids the difficulties of identifying the total amount of acquisition costs in particular scenarios.

Question 1: Timing of recognition of acquisition cost income and expense
Do you agree with the staff's analysis in paragraphs 10-15(c)? If not, how what alternative analysis would you proposed and why? Would you treat acquisition cost cash flows in the same way as all other cash flows used to measure the insurance contract liability, or would you require that the cash flows relating to acquisition costs should be separately identified and recognised over the contract term. Why?