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Staff Paper

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Project **Insurance contracts**

Topic **Acquisition costs – the story so far**

Purpose of this paper

1. This series of papers considers how an insurer should account for the cash flows relating to the recovery of acquisition costs, including the presentation of information about those cash flows. The papers discuss:
   (a) The story so far (this paper)
   (b) Acquisition costs in the building block approach (agenda paper 2C/83C)
   (c) Acquisition costs in the premium allocation approach (agenda paper 2D/83D).
2. Disclosures regarding acquisition costs will be considered in a future meeting.
3. These papers respond to the boards' request at their meeting on 27 February – 2 March 2012 for the staff to explore an approach that presents acquisition costs by netting them against the single/residual margin in the building block approach or against the liability for remaining coverage in the premium allocation approach, and presenting that amount separately from the present value of fulfilment cash flows[1]. In exploring that approach, the staff thinks it is useful to consider wider decisions about acquisition costs to ensure consistency of the overall approach.

[1] For the IASB, the present value of fulfilment cash flows is the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract, adjusted for the effects of uncertainty about the amount and timing of those future cash flows. For the FASB, there is no adjustment for the effects of uncertainty.

The story so far

4. This paper discusses :

   (a) The recovery of costs related to the acquisition of insurance contracts (paragraphs 5-7)

   (b) Acquisition costs in the building block approach:

      (i) The ED/DP proposals for the accounting for the cash flows through which the insurer recovers acquisition costs (paragraphs 8-20)

      (ii) Relevant tentative decisions since the ED/DP (paragraphs 21-25)

   (c) Acquisition costs in the premium allocation approach

      (i) The proposals in the ED (paragraphs 26-27)

      (ii) Relevant tentative decisions since the ED/DP (paragraphs 28 and 29)

   (d) Consistency between the treatment of acquisition costs in the building block approach, premium allocation approach and the revenue recognition project (paragraphs 30-33).

Recovery of costs related to the acquisition of insurance contracts

5. Insurers incur costs in acquiring and originating insurance contracts (acquisition costs). Those costs include commissions and other costs such as those for underwriting, medical inspection, and policy issuance. For some long-duration contracts, the first year commission could be higher than 100 percent of the first year's premium. Commissions are generally a much lower expense in subsequent years leveling off at a nominal amount of one to two percent after a specified number of years. In addition, insurers would incur other costs associated with the acquisition of insurance contracts (underwriting, medical inspection, and policy issuance costs) at or before inception of the contract. Thus, insurers can incur very high acquisition costs at contract inception and they expect to recover those costs over a period which may be a number of years for long duration contracts.

6. Insurers have a variety of ways of recovering any acquisition costs that they pay:

    (a) Most commonly, the insurer expects to recover acquisition costs through premiums. This could be either as part of a single premium received at inception of the contract, or as part of each recurring premium that a policyholder pays as long as it holds the contract.

    (b) If a policyholder cancels a contract earlier than expected, the insurer would receive fewer premiums than expected and therefore would not recover as much of the acquisition costs as it originally intended to. However, in some cases the insurer can nonetheless recover all or most of the acquisition costs that it originally expected to recover through premiums if the contracts:

        (i) Include a clawback feature that requires a broker to repay a commission that it had received at inception if the policyholder cancels early. Clawback features would recover only commissions and not other acquisition costs.

        (ii) Impose (explicit or implicit) surrender charges on the policyholder if it cancels the contract.

    (c) In some cases, the insurer avoids the need to impose surrender charges or clawback features by structuring commissions in a way that means they are paid to the agent only when the insurer receives each recurring premium (known as ‘trail commissions’). The insurer would set the amount of the trail commission paid per premium at an amount that would result in it recovering the total expected acquisition costs for the contract if the policyholder paid the expected number of premiums. However, because the commission is paid only when the policyholder pays a premium, cancellation by the policyholder earlier than expected would mean that the insurer will not pay for the part of acquisition costs that turn out not to be recoverable. Trail commissions relate only to commissions and not to other types of acquisition costs.

(d) If the insurer buys reinsurance, the reinsurance sometimes pays for the reinsurer's share of the acquisition costs incurred. This payment may be either separate and explicit ('ceding commission') or implicit, as a reduction in the premium paid by the cedant to the reinsurer.

7. Estimates of the cash flows for all these recovery mechanisms depend on mortality[2] and lapse assumptions. Different types of contracts structure the recovery of acquisition costs in different ways, and there may be a combination of recovery mechanisms for any given contract. However these different recovery mechanisms all achieve the same economic aim: to ensure that the insurer recovers the acquisition costs that it pays, regardless of changes in mortality or lapse.

Acquisition costs in the building block approach

The ED/DP proposals for the accounting for the cash flows through which the insurer recovers acquisition costs

8. The proposals in the ED/DP were carried forward from the IASB's 2007 DP. The premise in the 2007 DP is that if two contracts have identical terms, give rise to the identical risk profile and require identical servicing effort, the fact that the insurer incurs different acquisition costs for the two contracts (eg because of differences in distribution channel) would mean that it would charge a different premium for them (or accept a lower profit). In effect, the premium charged to the policyholder covers three things: the insurance obligation itself (including the resulting obligation to pay necessary maintenance and operating expenses and the costs of settling claims), acquisition costs, and an adequate profit. In a competitive market, the amount paid by the policyholder for coverage should approximate the value of the obligation from the insurer's perspective. Thus, a meaningful measure of the liability to the policyholder on day 1 is to measure the liability at the amount of the premium less the costs incurred in acquiring the contract.

[2] If a policyholder dies earlier than expected, the insurer will typically not recover the "outstanding" acquisition costs.

9. This is illustrated below:

	Contract A	Contract B
Obligation to provide coverage	**8,400**	**8,400**
Acquisition costs insurer expects to incur	**1,200**	**500**
Total = premium the insurer would charge to the policyholder	**9,600**	**8,900**

10. Applying this view[3], measuring the insurance contract liability at the premium the insurer would charge without first eliminating the amount the insurer expects to incur on acquisition costs would artificially gross up the insurance contract liability (to CU9,600 for Contract A and CU8,900 for Contract B).

11. The IASB's 2007 DP also proposed that an insurer would expense all acquisition costs as they are incurred and account for the cash flows from which it recovers acquisition costs[4] in the same way as all the other cash flows that it expects will arise in fulfilling the insurance contract liability.

12. In the discussions after the 2007 DP was published, both boards consistently held the view that insurers should recognize acquisition costs as an expense when incurred. However, the 2007 DP approach was modified in the 2010 ED/DP to reflect the boards' decision to calibrate the margin on day 1 to the premium, by measuring the insurance contract liability with reference to the premium after excluding from that premium the amount implicitly paid by the policyholder for acquisition costs. That assumes an insurer would require an identical margin for otherwise identical contracts. This is illustrated as follows:

[3] These examples are based on the assumption that the two insurers require the same profit to take on the same obligation to make the comparison between the liabilities easier. However there are multiple reasons why insurers will accept a different profit margin.

[4] In the ED/DP this treatment was limited to incremental acquisition costs.

	Contract A	Contract B
Fulfilment cash flows	**8,400**	**8,400**
Required margin to eliminate gain at inception[5]	**2,400**[6]	**2,400**
Amount recognised as liability	**10,800**	**10,800**
Acquisition costs insurer expects to incur	**1,200**	**500**
Total = premium the insurer would charge to the policyholder	**12,000**	**11,300**

13. In other words the insurer would measure the insurance contract liability using the premium as a starting point as follows (assuming the contract is not onerous):

	Contract A	Contract B
Premium charged	**12,000**	**11,300**
Acquisition costs the insurer expects to incur	**(1,200)**	**(500)**
Amount recognised as liability	**10,800**	**10,800**

14. One consequence of this approach is that part of the premium equal to the acquisition costs incurred at inception would be recognized at inception. The boards originally reached different conclusions about how to present this effect.

15. The IASB originally decided that an insurer should, at inception, recognize as revenue or income part of the premium equal to acquisition costs incurred at inception. The IASB tentatively decided it would achieve this by including the amount of any acquisition costs incurred at inception of the contract in

[5] For simplicity, we have assumed the risk adjustment is zero. Therefore, this paper uses the term "margin" to refer to both the residual and single margin.
[6] Although this example assumes that the insurer would charge an identical margin for an identical contract, in practice the insurer would probably accept a lower margin for contract A compared to Contract B. Thus the premium for Contract A might be equivalent to contract B.

the cash flows used to measure the insurance contract liability, in the same way as any other cash flows.[7]

16. The IASB's decision was based on its view that part of the premium received is compensation for acquisition costs incurred or to be incurred, not compensation for the insurance obligation itself. Thus, measuring the insurance contracts liability initially at the amount of total premium received would not represent faithfully the remaining obligations. This approach ensures that the measurement at inception should not be different for two insurance obligations that have identical contractual terms and risk profile and require identical servicing effort, but differ in price solely because the insurer incurred different acquisition costs and priced the contract to recover those costs.

17. The FASB originally decided that an insurer should not recognize revenue or income at inception to offset those costs incurred. As a result, the amount of any acquisition costs paid would reduce the measurement of the insurance contracts liability.[8]

18. The FASB's decision was based on their view that, consistent with the approach in the revenue recognition project, an insurer should not recognize premium before it provides any coverage because it has not satisfied any obligations to the policyholder before the coverage period. In addition, some believe that expensing acquisition costs as incurred (which may result in the insurer recognizing a loss) does not reflect the business model of an insurer because it does not reflect that the insurer expects that it will recover those costs (because the contract as a whole is expected to be profitable).

19. In developing the IASB's ED and the FASB's DP, the boards did not need to reconcile their divergent views on whether premium should be recognised when acquisition costs are incurred. However, because the ED proposed a summarised margin approach for presentation in the statement of comprehensive income, no revenue or expense was presented. This meant that the question of whether the insurer should at inception recognize revenue

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[7] The journal entries when acquisition costs are incurred and paid would be Dr Insurance contract liability, Cr revenue. Dr acquisition cost expense, Cr cash.

[8] The net impact when acquisition costs are paid would be reflected as Dr margin, Cr cash.

to offset the acquisition costs incurred at inception did not arise and the boards did not need to reconcile their differing views. Both approaches would show the same net effect in profit and loss (because the revenue of CU1,200 is offset by the expense of CU1,200 and nets to zero.)

20. As a result the boards were able to come to a common view on how to implement their decision to measure the insurance contract liability with reference to the premium after excluding from that premium the amount implicit paid by the policyholder for acquisition costs. This was achieved by including those acquisition costs in the cash flows used to determine the margin (in the same way as all other cash flows that would arise in fulfilling the contract).

Relevant tentative decisions since the ED/DP

21. Since December 2010, the boards have discussed papers on acquisition costs in the building block approach and the premium allocation approach at the following meetings:

    (a) 1-2 February 2011, Agenda paper 3B/55B *Acquisition costs*

    (b) 1-2 March 2011, Agenda paper 2G/58G *Follow up on acquisition costs*

    (c) 27 April 2011, Agenda paper 1/65 *Short duration contracts*

    (d) 13 June 2011, Agenda paper 3E/70E *Acquisition costs revisited* and 3F/70F *Cross cutting issues on acquisition costs*

    (e) 20-22 July 2011, Agenda papers 8A-8C/71A-71C on the *premium allocation approach*

    (f) 25-27January 2012, Agenda paper 2B/78B *Mechanics of applying premium allocation approach*

    (g) 27 February-2 March 2012, Agenda paper 3G/79G *Premium allocation approach mechanics*

22. In developing those papers, the staff carried forward the proposal in the ED/DP that acquisition costs should be treated as one of the cash flows used to measure the insurance contract liability. That proposal had been

extensively debated by the IASB and FASB in developing the ED/DP (ie in meetings in April 2009, July 2009, March 2010 and June 2010) and was widely accepted in the comment letters.

23. Therefore, since the ED/DP was published, the boards have not reconsidered the approach for accounting for acquisition costs as one of the cash flows that arise as the insurer fulfils the insurance contract. In keeping with the general approach for the redeliberations, we have not routinely asked the boards to confirm matters that were proposed in the ED/DP for which there were no significant issues raised by constituents. As a result the majority of these papers addressed only what costs should be considered acquisition costs, an issue raised in the comment letters[9]. That issue is not revisited in this paper.

24. However, an important development was the boards' decision in October 2011 that an insurer should present premiums[10], claims and benefits in the statement of comprehensive income. As a result, the different views of the IASB and FASB about whether premium should be recognized when acquisition costs are incurred becomes important again. That difference drives the different views on presentation between the boards (and also on how to define the acquisition costs that would be included in the cash flows used to measure the insurance contract liability). Accordingly, this paper considers the recognition of premiums when acquisition costs are incurred and the presentation of the cash flows through which the insurer will recover acquisition costs as interrelated points.

25. In addition, since the ED/DP, the boards issued a revised Exposure Draft *Revenue from Contracts with Customers*, in which the boards proposed that

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[9] In answering that question, the boards' tentative decisions for defining such acquisition costs differ:

1. Both boards tentatively decided that the acquisition costs to be included in the initial measurement of a portfolio of insurance contracts should be all of the direct costs that the insurer will incur in acquiring the contracts in the portfolio. The boards provided a list of the costs that would qualify as direct acquisition costs.
2. The FASB tentatively decided that the acquisition costs included in the cash flows used to determine the margin should be limited to those costs related to successful acquisition efforts, while the IASB tentatively decided that ***all*** cash flows relating to the recovery of acquisition costs should be included in the cash flows used to determine the margin.

[10] Agenda paper 2A/83A discusses how to present the premiums in the statement of comprehensive income in each reporting period.

an entity shall recognize as an asset the incremental costs[11] of obtaining a contract with a customer if the entity expects to recover those costs and that the acquisition cost asset should be amortised on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates.

Acquisition costs in the premium allocation approach

The proposals in the ED/DP

26. The premium allocation approach in the IASB's ED[12] had an inconsistency between measurement and presentation, relating to the presentation of acquisition costs:

    (a) The measurement of the insurance contract liability was consistent with building block approach. In other words, there is no separate asset recognised and the liability was measured at initial recognition at the amount of the premium less the acquisition costs.

    (b) The presentation in profit and loss was consistent with the approach in the revenue recognition model, ie:

        (i) The full premium, including the part of the premium that recovers the acquisition costs, was recognised as revenue in a systematic way that best reflects the exposure from providing insurance coverage, such as over the coverage period on the basis of time or on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time over the coverage period,

        (ii) The acquisition costs used to gross up the obligation to provide coverage were 'amortised' over the coverage period, even though no separate asset was recognised.

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[11] The revenue recognition ED goes onto state that the "incremental costs of obtaining a contract are those costs that an entity incurs in its efforts to obtain a contract with a customer and that it would not have incurred if the contract had not been obtained (for example, a sales commission). Costs to obtain a contract that would have been incurred regardless of whether the contract was obtained shall be recognised as an expense when incurred, unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained."

[12] At the time of publishing the DP, the FASB had not determined whether the acquisition costs would reduce the liability for remaining coverage.

27. The resulting pattern of recognition of premium revenue is the same as the pattern that would arise if the acquisition costs had been recognised as an asset, and is consistent with the recognition pattern in most jurisdictions today.[13]

Relevant tentative decisions since the ED/DP

28. At their meeting on 27 February – 2 March 2012, the boards tentatively decided that the costs deducted from the premium in the premium allocation approach should be the same as those that would be treated as acquisition costs in the building block approach. In doing so, the boards noted that their decision on the treatment of acquisition costs in the premium allocation approach reflected their preference that acquisition costs be treated consistently between the building block approach and in the premium allocation approach.

29. In considering the presentation of acquisition costs for the premium allocation approach, some board members raised concerns about the proposed accounting for acquisition costs in the building block approach (which had been carried forward from the proposals in the ED/DP without further debate) and asked the staff to explore an approach that presents acquisition costs by netting them against the single/residual margin in the building block approach or against the liability for remaining coverage in the premium allocation approach, and presenting that amount separately from the present value of fulfilment cash flows.

[13] However, there may be differences in the recognition pattern as a result of the requirement to reflect the time value of money in the liability for remaining coverage. At the February 27, 2012 joint meeting, the boards tentatively decided that discounting and interest accretion to reflect the time value of money should be required in measuring the liability for remaining coverage for contracts that have a significant financing component, as defined according to the characteristics of a significant financing component under the revenue recognition proposals. However, as a practical expedient, insurers need not apply discounting or interest accretion in measuring the liability for remaining coverage if the insurer expects at contract inception that the period of time between payment by the policyholder of all or substantially all of the premium and the satisfaction of the insurer's corresponding obligation to provide insurance coverage will be one year or less. The liability for remaining coverage does not reflect discounting under current GAAP in most jurisdictions.

Consistency in treatment of acquisition costs in the building block approach and the revenue recognition project

30. The boards also asked the staff to consider why there was an inconsistency between the treatment of acquisition costs in the insurance contracts project and their treatment in the 2011 ED *Revenue from Contracts with Customers*. That ED proposed that an entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs, but that an entity should present the asset separately from the contract asset or liability and amortize the asset in the same pattern as the entity recognizes revenue as it satisfies its performance obligation(s).

31. The rationale for that proposal is set out in the Basis for Conclusions, as follows:

> *Other standards require some of the costs of obtaining a contract to be included in the carrying amount of an asset on initial recognition.*
>
> *During redeliberations, the Boards decided that in some cases, it might be misleading for an entity to recognize all the costs of obtaining a contract as expenses when incurred. For example, the Boards observed that recognizing the full amount of a sales commission as an expense at inception of a long-term service contract (when that sales commission is reflected in the pricing of that contract and expected to be recovered) could be viewed as creating an accounting mismatch. That is because the inflows from which the commission is recovered would be recognized as revenue over future periods.*

32. Some believe a difference in the requirement to recognize an asset for the right to recover acquisition costs between the insurance contracts model and the revenue recognition model is justified:

    (a) The objective of the insurance contracts project differs from that of the revenue recognition project. The insurance contracts project focuses on the explicit measurement of an insurance contract from the insurer's perspective. At initial recognition, that explicit measurement is calibrated to the amount of premiums receivable, and the liability from the contract is remeasured afterwards. In contrast, the revenue

project does not focus on explicitly measuring a contract with a customer[14]. Rather, the proposed revenue model focuses solely on whether the entity has satisfied any of its performance obligations to the customer. It does this by requiring the entity to allocate the transaction price to the performance obligations and recognizing revenue as those obligations are satisfied.[15]

(b) In the revenue recognition model, an entity recognises contract assets and liabilities when one party performs under the contract only to the extent of the consideration received or receivable from the customer. The revenue recognition model would create a mismatch if the full amount of a sales commission is recognised as an expense at inception of a long-term service contract (when that sales commission is reflected in the pricing of that contract and expected to be recovered). That mismatch is avoided by the recognition of an asset for the right to recover the acquisition costs and subsequent amortisation. In contrast, in the insurance contracts model, there is no mismatch because the insurer measures the insurance liability by comparing the total to be paid by the policyholder with the total cash flows needed to fulfil the contracts and with the costs incurred in the acquisition effort.

33. However, others believe that, while there are reasons for differences in presentation, there are not sufficient reasons for differences in the recognition of revenue to recover the acquisition costs. In particular:

(a) The revenue recognition ED does not allocate any of the transaction price to costs that are not part of the performance obligation(s) because the boards were uncomfortable recognizing revenue before the entity had transferred goods or services to the customer. This reasoning applies equally to insurance contracts. Even if the payment

[14] However, both the insurance contracts project and the revenue recognition project require that the entity does not recognize a day one gain and to recognise an onerous performance obligation if the lowest cost of settling the performance obligation exceeds the amount of the transaction price allocated to that performance obligation. However, acquisition costs are not included in this determination. The costs used to determine an onerous performance obligation are those that relate directly to satisfying the performance obligation or those that the entity would pay to exit the performance obligation.

[15] The revenue recognition model does not regard the payment of acquisition costs as arising from a performance obligation. Furthermore, in the revenue recognition model, the boards were uncomfortable recognizing revenue before the entity had transferred goods or services to the customer.

of benefits and claims can be regarded as the satisfaction of a performance obligation, that logic does not extend to the acquisition costs, which are not paid to policyholders and are not paid to fulfil the benefit obligations to the policyholders. Similarly, the policyholder receives no benefit from the acquisition costs and views the insurance contract in terms of the value they expect to receive (compensation if a specified uncertain future event adversely affects them,) for the premiums they have paid or will pay.

(b) The approach in revenue recognition to recognize an asset for the right to recover acquisition costs would result in the recognition of expenses incurred in acquiring the contract in the same period that the revenue from the contract is recognised.

Appendix A: Comparison with other standards

Measurement of acquisition costs under revenue recognition

A1. In the 2011 Exposure Draft, *Revenue from Contracts with Customers*, the Boards proposed that an entity shall recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs. The ED also proposes that non-incremental acquisition costs shall be recognized as an expense when incurred unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

A2. The Exposure Draft provides a practical expedient whereby an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

A3. The Exposure Draft states that the acquisition costs recognized as an asset shall be amortized on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under an anticipated contract that the entity can identify specifically (for example, services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved). An entity shall update the amortization to reflect a significant change in the entity's expected pattern of transfer of the goods or services to which the asset relates. In addition, an entity shall recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized for acquisition costs exceeds: (a) The remaining amount of consideration to which an entity expects to be entitled in exchange for the goods or services to which the asset relates, less (b) The costs that relate directly to providing those goods or services.

Leases

A4. 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.

A5. At the 21 March 2011 joint board meeting, the boards affirmed the decision in the leases Exposure Draft that lessees and lessors should capitalize initial direct costs by adding them to the carrying amount of the right-of-use asset and the right to receive lease payments, respectively.

A6. The Boards tentatively decided that lessees should amortize the right-of-use asset on a systematic basis that reflects the pattern of consumption of the expected future economic benefits. However, upon further consideration of the lessee model, the Boards considered different methods of amortizing the right-of-use asset. More specifically, the Boards discussed the following two approaches to amortizing the right-of-use asset: the underlying asset approach, and the interest-based amortization approach. The Boards directed the staff to undertake further outreach and research on those two approaches before they reach a tentative decision on which approach to propose in the re-exposure document.

A7. The Boards discussed the receivable and residual approach and tentatively decided that for all lease contracts within the scope of that approach, a lessor should: initially measure the right to receive lease payments at the present value of the lease payments, discounted using the rate the lessor charges the lessee, and subsequently measure at amortized cost applying an effective interest method.

A8. Thus, because the acquisition costs are part of the right-of-use asset, they are also amortised over time.

Financial instruments

A9. In IFRSs, the treatment of 'acquisition costs', which includes fees paid on the origination of financial instruments depends on whether such costs are an integral part of the effective interest rate of a financial instrument or not. Both IAS 39 (paragraph 43) and IFRS 9 (paragraph 5.1.1) require that a financial asset or financial liability not at fair value through profit or loss should be recognised initially at its fair value plus transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. Transaction costs are not added to the fair value for financial assets or financial liabilities measured at fair value.

A10. The classification of costs as an integral part of the effective interest rate of a financial instrument is in accordance with paragraph 14 in the Illustrative Examples to IAS 18, as follows:

14 *Financial service fees.*

The recognition of revenue for financial service fees depends on the purposes for which the fees are assessed and the basis of accounting for any associated financial instrument. The description of fees for financial services may not be indicative of the nature and substance of the services provided. Therefore, it is necessary to distinguish between fees that are an integral part of the effective interest rate of a financial instrument, fees that are earned as services are provided, and fees that are earned on the execution of a significant act.

(a) *Fees that are an integral part of the effective interest rate of a financial instrument.*

Such fees are generally treated as an adjustment to the effective interest rate. However, when the financial instrument is measured at fair value with the change in fair value recognised in profit or loss, the fees are recognised as revenue when the instrument is initially recognised.

(i) *Origination fees received by the entity relating to the creation or acquisition of a financial asset other than one that under IFRS 9 is measured at fair value through profit or loss.*

Such fees may include compensation for activities such as evaluating the borrower's financial condition, evaluating and recording guarantees, collateral and other security arrangements, negotiating the terms of the instrument, preparing and processing documents and closing the transaction. These fees are an integral part of generating an involvement with the resulting financial instrument and, together with the related transaction costs[16] (as defined in IAS 39), are deferred and recognised as an adjustment to the effective interest rate.

(ii) *Commitment fees received by the entity to originate a loan when the loan commitment is outside the scope of IFRS 9.*

If it is probable that the entity will enter into a specific lending arrangement and the loan commitment is not within the scope of IFRS 9, the commitment fee received is regarded as compensation for an ongoing involvement with the acquisition of a financial instrument and, together with the related transaction costs (as defined in IAS 39), is deferred and recognised as an adjustment to the effective interest rate. If the commitment expires without the entity making the loan, the fee is recognised as revenue on expiry. Loan commitments that are within the scope of IFRS 9 are accounted for as derivatives and measured at fair value.

(iii) *Origination fees received on issuing financial liabilities measured at amortised cost.*

These fees are an integral part of generating an involvement with a financial liability. When a financial liability is not classified as at fair value through profit or loss, the origination fees received are included, with the related transaction costs (as defined in IAS 39) incurred, in the initial carrying amount of the financial liability and recognised as an adjustment to the effective interest rate. An entity distinguishes fees and costs that are an integral part of the effective interest rate for the financial liability from origination fees and transaction costs relating to the right to provide services, such as investment management services.

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[16] In *Improvements to IFRSs* issued in May 2008, the Board replaced the term 'direct costs' with 'transaction costs' as defined in paragraph 9 of IAS 39. This amendment removed an inconsistency for costs incurred in originating financial assets and liabilities that should be deferred and recognised as an adjustment to the underlying effective interest rate. 'Direct costs', as previously defined, did not require such costs to be incremental.

(b) *Fees earned as services are provided.*

(i) *Fees charged for servicing a loan.*

Fees charged by an entity for servicing a loan are recognised as revenue as the services are provided.

(ii) *Commitment fees to originate a loan when the loan commitment is outside the scope of IFRS 9.*

If it is unlikely that a specific lending arrangement will be entered into and the loan commitment is outside the scope of IFRS 9, the commitment fee is recognised as revenue on a time proportion basis over the commitment period. Loan commitments that are within the scope of IFRS 9 are accounted for as derivatives and measured at fair value.

(iii) *Investment management fees.*

Fees charged for managing investments are recognised as revenue as the services are provided.

Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. As in IAS 39, an incremental cost is one that would not have been incurred if the entity had not secured the investment management contract. The asset represents the entity's contractual right to benefit from providing investment management services, and is amortised as the entity recognises the related revenue. If the entity has a portfolio of investment management contracts, it may assess their recoverability on a portfolio basis.

Some financial services contracts involve both the origination of one or more financial instruments and the provision of investment management services. An example is a long-term monthly saving contract linked to the management of a pool of equity securities. The provider of the contract distinguishes the transaction costs relating to the origination of the financial instrument from the costs of securing the right to provide investment management services.

(c) *Fees that are earned on the execution of a significant act.*

The fees are recognised as revenue when the significant act has been completed, as in the examples below.

(i) *Commission on the allotment of shares to a client.*

The commission is recognised as revenue when the shares have been allotted.

(ii) Placement fees for arranging a loan between a borrower and an investor.

The fee is recognised as revenue when the loan has been arranged.

(iii) *Loan syndication fees.*

A syndication fee received by an entity that arranges a loan and retains no part of the loan package for itself (or retains a part at the same effective interest rate for comparable risk as other participants) is compensation for the service of syndication. Such a fee is recognised as revenue when the syndication has been completed.

A11. The IASB's exposure draft Amortised Cost and Impairment deals with financial instruments that are measured at amortised cost (rather than fair value). In measuring financial instruments at amortised cost, the entity uses an effective interest method

which generally allocates by way of amortisation any fees, points paid or received, transaction costs and other premiums or discounts included in the calculation of the effective interest rate over the expected life of the financial instrument. Transaction costs included in the effective interest method 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.

A12. The FASB has not discussed the costs of obtaining a financial instrument during redeliberations of its ED, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities,* in the accounting for financial instruments project. The ED included:

> An entity shall include in net income the transaction fees and costs related to a financial instrument to which paragraph 12(a) applies. For financial assets that meet the criteria to recognize qualifying changes in fair value in other comprehensive income, certain loan origination fees, net of direct loan origination costs, as defined in Subtopic 310-20, shall be deferred. Those fees and costs shall be recognized in net income as a yield adjustment over the life of the related financial asset.
>
> In addition, as discussed in paragraph 13, interest income determined on the basis of the financial asset's effective interest rate shall include the effects of amortizing certain loan origination fees, net of direct loan origination costs. The initial measurement of financial assets that meet the criteria to recognize qualifying changes in fair value in other comprehensive income is based on the transaction price, which includes amounts that qualify as loan origination fees and direct loan origination costs as defined in Subtopic 310-20. By recognizing the change in fair value of such financial assets, those loan origination fees and direct loan origination costs are initially deferred in other comprehensive income and recognized in net income as a yield adjustment over of the life of the related financial asset.

A13. In US GAAP, the treatment of 'acquisition costs', which includes fees paid on the origination of financial instruments, is included in Subtopic 310-20 (formerly FAS 91). It includes:

Recognition

Loan Origination Fees and Direct Loan Origination Costs

25-2 Loan origination fees shall be deferred. Likewise, direct loan origination costs shall be deferred.

Other Lending-Related Costs

25-3 All other lending-related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration, shall be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time shall be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and shall be charged to expense as incurred.

25-5 Fees paid to a service bureau for loan processing are not eligible for deferral as direct loan origination costs under the definition of that term because the services were performed after the loan has already been made; the costs are not origination costs.

25-6 Bonuses based on successful production of loans that are paid to employees involved in loan origination activities are partially deferrable as direct loan origination costs under the definition of that term. Bonuses are part of an employee's total compensation. The portion of the employee's total compensation that may be deferred as direct loan origination costs is the portion that is directly related to time spent on the activities contemplated in the definition of that term and results in the origination of a loan.

25-7 If compensation for an employee traditionally paid by salary or hourly wage is switched wholly or partially to commissions on successful loan production, such costs would be partially deferrable as direct loan origination costs under the definition of that term. As specified in the preceding paragraph, only the portion of the employee's total compensation directly related to time spent on activities contemplated in the definition of that term for completed loans would be deferred. Commission-based compensation arrangements between a lender and its employees may be similar to arrangements a lender may have with independent third parties such as loan brokers. However, when origination activities are performed by the lender's employees, the lender must allocate compensation costs applicable to the activities contemplated in the definition of direct loan acquisition costs based on the portion of time spent by employees. An allocation of the employees' total compensation between origination and other activities is made so that only those costs associated with those lending activities contemplated in the definition of that term are deferred for completed loans, even if commissions are 100 percent of such compensation and are based solely on completed loan transactions.

Commitment Fees

25-11 Except as set forth in paragraph 310-20-35-3, fees received for a commitment to originate or purchase a loan or group of loans shall be deferred.

25-12 Direct loan origination costs incurred to make a commitment to originate a loan shall be offset against any related commitment fee and the net amount recognized as set forth in paragraph 310-20-35-3.

25-13 If qualifying costs associated with commitments exceed commitment fees received (or if no fee is charged), whether or not the resulting net cost may be deferred depends on the likelihood of the commitment being exercised. This Subtopic applies to both nonrefundable fees and costs, and paragraphs 310-20-35-3 and 310-20-25-1 may require that the net of such items be deferred. However, if the likelihood that the commitment will be exercised is remote, any net costs shall be charged to expense immediately rather than deferred and amortized on a straight-line basis over the commitment period.

25-14 Fees received for providing commercial letters of credit are covered by this Subtopic. Such fees are considered commitment fees, and the accounting is specified in paragraph 310-20-35-3.

Loan Syndication Fees

25-19 The entity managing a loan syndication (the syndicator) shall recognize loan syndication fees when the syndication is complete unless a portion of the syndication loan is retained. If the yield on the portion of the loan retained by the syndicator is less than the average yield to the other syndication participants after considering the fees passed through by the syndicator, the syndicator shall defer a portion of the syndication fee to produce a yield on the portion of the loan retained that is not less than the average yield on the loans held by the other syndication participants.

25-20 All transactions that are structured legally as loan syndications shall be accounted for as loan syndications in accordance with the provisions of this Subtopic.

Independent Third Parties

25-25 If an entity utilizes a third party for loan originations and the third party is not considered an independent third party for several reasons but also is not an employee of the entity, the entity shall defer those costs directly related to specified activities that can be determined to meet the criteria for direct loan origination costs under the definition of that term as long as those costs would not have been incurred but for that loan.

25-26 Fees paid to independent third parties for advisory services regarding loan origination activities, even if those same activities are performed internally, are not considered to be incurred for the specified activities set forth in the definition of the direct loan acquisition costs term and shall be charged to expense as incurred whether paid to independent third parties or performed internally.

25-27 Fees paid to an independent third party, or incurred internally, for portfolio management or investment consultation are considered other costs incurred in connection with acquiring purchased loans or committing to purchase loans because they constitute investment advisory costs, not loan origination costs. Therefore, such costs shall be charged to expense in accordance with paragraph 310-20-35-15 whether the costs are paid to independent third parties or incurred internally. In some circumstances judgment may be necessary to determine if a third party is independent.

Subsequent Measurement

Loan Origination Fees and Costs

35-2 Loan origination fees deferred in accordance with paragraph 310-20-25-2 shall be recognized over the life of the loan as an adjustment of yield (interest income). Likewise, direct loan origination costs deferred in accordance with that paragraph shall be recognized as a reduction in the yield of the loan except as set forth in paragraph 310-20-35-12 (for a troubled debt restructuring). Paragraph 310-20-30-2 explains that loan origination fees and related direct loan origination costs for a given loan shall be offset and only the net amount shall be amortized.

Commitment Fees and Costs

35-3 Except as set forth in this paragraph, fees received for a commitment to originate or purchase a loan or group of loans shall be, if the commitment is exercised, recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment:

a) If the entity's experience with similar arrangements indicates that the likelihood that the commitment will be exercised is remote, the commitment fee shall be recognized over the commitment period on a straight-line basis as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise shall be recognized over the life of the loan as an adjustment of yield. The term *remote* is used here, consistent with its use in Topic 450, to mean that the likelihood is slight that a loan commitment will be exercised before its expiration.

b) If the amount of the commitment fee is determined retrospectively as a percentage of the line of credit available but unused in a previous period, if that percentage is nominal in relation to the stated interest rate on any related borrowing, and if that borrowing will bear a market interest rate at the date the loan is made, the commitment fee shall be recognized as service fee income as of the determination date.

Interest Method and Other Amortization Matters

35-17 Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest.

35-18 Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraphs 310-20-35-21 through 35-24. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization. See paragraphs 835-30-35-2 through 35-5 for guidance

concerning the interest method. Under the provisions of this Subtopic, the interest method shall be applied as follows when the stated interest rate is not constant throughout the term of the loan:

a) If the loan's stated interest rate increases during the term of the loan (so that interest accrued under the interest method in early periods would exceed interest at the stated rate), interest income shall not be recognized to the extent that the net investment in the loan would increase to an amount greater than the amount at which the borrower could settle the obligation. Prepayment penalties shall be considered in determining the amount at which the borrower could settle the obligation only to the extent that such penalties are imposed throughout the loan term. (See Section 310-20-55.) Accordingly, a limit is imposed on the amount of periodic amortization that can be recognized. However, that limitation does not apply to the capitalization of costs incurred (such as direct loan origination costs and purchase premiums) that cause the investment in the loan to be in excess of the amount at which the borrower could settle the obligation. The capitalization of costs incurred is different from increasing the net investment in a loan through accrual of interest income that is only contingently receivable.

b) If the loan's stated interest rate decreases during the term of the loan, the stated periodic interest received early in the term of the loan would exceed the periodic interest income that is calculated under the interest method. In that circumstance, the excess shall be deferred and recognized in those future periods when the constant effective yield under the interest method exceeds the stated interest rate. (See Section 310-20-55.)

c) If the loan's stated interest rate varies based on future changes in an independent factor, such as an index or rate (for example, the prime rate, the London Interbank Offered Rate [LIBOR], or the U.S. Treasury bill weekly average rate), the calculation of the constant effective yield necessary to recognize fees and costs shall be based either on the factor (the index or rate) that is in effect at the inception of the loan or on the factor as it changes over the life of the loan. (See Section 310-20-55.) A variable rate loan whose initial rate differs from the rate its base factor would produce is also subject to the provisions of (a) and (b).

35-19 The preceding paragraph provides that when a loan's stated interest rate varies based on future changes in an independent factor, the lender shall calculate a constant effective yield by using the independent factor in effect at the inception of the loan or the factor as it changes over the life of the loan. In applying the guidance in (c) in the preceding paragraph, the lender may not change from one alternative to the other during the life of the loan. The lender must select one of the two alternatives and apply the method consistently throughout the life of the loan.

35-20 In a period in which the independent factor on a variable rate loan changes, the constant effective yield is recalculated not from the inception of the loan but from the time of the change. See Example 9 (paragraph 310-20-55-43) for an illustration.

35-21 Certain loan agreements provide no scheduled payment terms (demand loans); others provide the borrower with the option to make multiple borrowings up to a specified maximum amount, to repay portions of previous borrowings, and then reborrow under the same contract (revolving lines of credit).

35-22 For a loan that is payable at the lender's demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with any of the following:

a) The understanding between the borrower and lender

b) If no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding; any unamortized amount shall be recognized when the loan is paid in full.

Such estimates should be monitored regularly and revised as appropriate. If, contrary to expectation, a loan remains outstanding beyond the anticipated payment date, no adjustment is required.

35-23 For revolving lines of credit (or similar loan arrangements), the net fees or costs shall be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract. If the borrower pays all borrowings and cannot reborrow under the contract, any unamortized net fees or costs shall be recognized in income upon payment. The interest method shall be applied to recognize net unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.

35-24 For example, if the loan agreement provides the borrower with the option to convert a one-year revolving line of credit to a five-year term loan, during the term of the revolving line of credit the lender would recognize the net fees or costs as income on a straight-line basis using the combined life of the revolving line of credit and term loan. If the borrower elects to convert the line of credit to a term loan, the lender would recognize the unamortized net fees or costs as an adjustment of yield using the interest method. If the revolving line of credit expires and borrowings are extinguished, the unamortized net fees or costs would be recognized in income upon payment.

35-25 If the borrower continues to have a contractual right to borrow under the revolving line of credit, net fees and costs associated with revolving lines of credit shall be amortized over the term of the revolver even if the revolver is unused for a period of time.

Lending Transactions Unrelated to the Origination of Loans

35-34 A lender may receive fees for lending transactions unrelated to the origination of loans. For example, a borrower may pay a fee to the lender for extending the contractual maturity of an existing loan, for converting an adjustable-rate mortgage to a fixed-rate loan, or for the assumption of an existing loan by a new borrower. The fees shall be recognized over the remaining life of the loan as an adjustment of yield. In each situation, the lender has made some form of concession to

the initial or underlying borrower by altering the original terms of the initial underwriting; thus, any fees received shall be recognized as an adjustment of yield over the remaining life of the loan.

Appendix B: comparison with US GAAP

Current US GAAP measurement of acquisition costs

A14. Under current U.S. GAAP, costs that meet the definition of acquisition costs pursuant to ASU 2010-26 are recognized as assets and commonly referred to as “deferred acquisition costs.” Deferred acquisition costs are amortized over time using amortization methods dependent upon the nature of the underlying insurance product (that is, proportional to revenues, based on a contract's estimated gross profit, or based on a contract's estimated gross margin). Other costs that do not meet the definition – such as those relating to investment management, general administration, and policy maintenance – are charged to expense as incurred.

(a) For short duration contracts, capitalized acquisition costs are amortized over of the life of the contract in proportion to premium revenue recognized.

(b) For traditional long-duration contracts, capitalized acquisition costs are amortized according to a percentage of premiums.

(c) For universal life-type contracts, deferred annuities, and variable and equity-based life and annuity products, capitalized acquisition costs are amortized according to a percentage of estimated gross profits. Estimated gross profits used to amortize acquisition costs are updated for actual experience and current future projections each reporting period.

(d) For certain investment contracts, capitalized acquisition costs are amortized using the interest method. That method recognizes acquisition and interest costs as expenses at a constant rate to net policy liabilities.

(e) For long-duration participating life insurance contracts, capitalized acquisition costs are amortized over a percentage of estimated gross margins.