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Staff Paper

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Project **Insurance contracts**

Topic **Acquisition costs in the building block approach**

Purpose of this paper

1. This paper considers how an insurer should account for the cash flows relating to the recovery of acquisition costs in the building block approach, including the presentation of information about those cash flows. The relevant background material is provided in agenda paper 2B/83B.
2. Follow up issues relating to this issue are discussed in agenda paper 2D/83D.

Staff recommendations

3. Both the IASB and FASB staff recommend that an insurer should include acquisition costs in the cash flows used to determine the margin (and hence the insurance contract liability).
4. The IASB staff recommends, consistent with the IASB's previous views, that an insurer should account for 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, and recognize premium income equal to, and offsetting, those costs when the acquisition costs are incurred.
5. The FASB staff recommends that an insurer should recognise a reduction in the margin when the acquisition costs are incurred, with no effect in the statement of comprehensive income. The acquisition costs would be shown net against the residual/single margin and that net amount would be allocated to profit or loss using the allocation pattern the boards have previously determined for the single/residual margin.

Staff analysis

6. Agenda paper 2B/83B notes the boards' tentative decisions that insurers should present information about premiums, claims and expenses on the face of the statement of comprehensive income. This decision means that the boards need to reconsider whether:

   (a) acquisition costs should be recognized as an expense when incurred, together with the related premium income, or

   (b) no expense or income should be recognized when acquisition costs are incurred. The acquisition costs would be shown net against the residual/single margin and that net amount would be allocated to profit or loss using the allocation pattern the boards have previously determined for the single/residual margin.

7. Furthermore, in deliberations since the end of the comment period, some board members have expressed the view that a disadvantage of including acquisition costs in the cash flows used to measure the insurance contract liability is that it results in changes to the insurance contracts liability both as a result of paying acquisition costs when those costs are incurred and when paying policyholder claims and benefits. Those board members believe that better information would be provided if the changes in the liability arising from acquisition costs would be separated from those arising from other changes in cash flows. Some note that this information is currently provided in some jurisdictions where the right to recover acquisition costs is recognised as an asset separate from the insurance contract liability, rather than as part of the insurance contract liability. They do not believe that the loss of such information improves financial reporting.

8. Finally, some suggest that more transparent information might be presented in the statement of comprehensive income if an insurer would show the release of the margin net of acquisition costs in a separate line item from other changes in the insurance contract liability.

9. Accordingly, the staff considers three alternatives for presenting the portion of premiums that the insurer charges to enable it to recover acquisition costs:

   (a) Alternative A: an approach which recognises the right to recover acquisition costs as an asset.

   (b) Alternative B: an approach which includes acquisition costs in the cash flows used to determine the margin and which would require an insurer to recognise a reduction in the margin when the acquisition costs are incurred, with no effect in the statement of comprehensive income. The acquisition costs would be shown net against the residual/single margin and allocated to profit or loss in the same way as the single/residual margin. Changes in the insurance contract liability arising from acquisition costs would be shown with the release of margin and not as changes in the cash flows. Alternative B is a variant of the FASB's view in developing the 2010 DP.

   (c) Alternative C: an approach which includes acquisition costs in the cash flows used to determine the margin and would require an insurer to expense the acquisition costs and recognise income equal to, and offsetting, those costs when the acquisition costs are incurred. Changes in the insurance contract liability arising from acquisition costs would be shown in the same way as changes in the cash flows. Alternative C is consistent with the IASB's view in developing the 2010 ED.

10. We illustrate the accounting for these alternatives in the Appendix.

11. The staff does not consider in this paper the alternative of excluding acquisition costs from the cash flows expected to fulfil the contract and expensing all acquisition costs when incurred. That approach had been rejected by both boards in previous discussions. This was also an approach that was rejected after being proposed in the

2010 revenue recognition exposure draft[1]. The staff has not repeated the arguments in favour or against this approach in this paper, but notes that they may be found in agenda paper 3B/55B from February 2011.

Rejection of an approach which recognises the right to recover acquisition costs as an asset

Existing practice

12. Many existing accounting models measure insurance liabilities initially at the amount of the premium received, with deferral of acquisition costs and many think that presenting the right to recover acquisition costs as a separate asset reflects the economics of an insurance contract. Those with this view argue that:

    (a) an insurer is willing to incur significant acquisition costs in the expectation that doing so will create a customer relationship. For example, for life insurance contracts, a predictable number of policyholders renew (continue) their contracts resulting in the recovery of the acquisition costs incurred by the insurer. Thus, acquisition costs are a proxy for the cost of a recognizable customer relationship intangible asset.

    (b) an asset representing the right to recover acquisition costs is a proxy measure of an intangible asset representing the present value of future profits ("PVFP"). They note that if an insurer were to sell a block of its business, purchase reinsurance, or securitize a portfolio of insurance contracts, it would include an amount for the recovery of acquisition costs as part of the price of the block of insurance contracts, charge a ceding commission, or monetize the acquisition costs it had incurred.[2] From the purchaser's perspective, if the

[1] As discussed in the Basis for Conclusions to the 2011 ED *Revenue from Contracts with Customers* the 2010 exposure draft noted that an entity may obtain a contract asset as a result of its efforts to obtain a contract (because the measure of the remaining rights might exceed the measure of the remaining obligations). However, that ED proposed that an entity should recognise a contract asset and revenue only as a result of satisfying performance obligations in the contract and specified that the contract asset would be measured at zero at contract inception and any costs of obtaining a contract would be recognised as an expense when incurred. During redeliberations, the boards decided that, in some cases, it might be misleading for an entity to recognise all the costs of obtaining a contract as expense when incurred. For example, the boards observed that recognising 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) would fail to acknowledge the existing of an asset. Therefore, the boards decided that an entity should recognise an asset from the costs of obtaining a contract but present the asset separately from the contract asset or liability.

[2] For example, suppose an insurer issues contracts on day 0 with premium of CU100, expected claims CU80, acquisition costs of CU6. Ignore any risk adjustment and time value of money. The margin is CU14. If, on day 1, the insurer transfers the contract to another insurer (eg via reinsurance) before any coverage has been provided

amount received in exchange for the block of business is less than the expected present value of the cash flows, the difference is recorded as an intangible asset, typically referred to as value of business acquired ("VOBA") or present value of future profits ("PVFP").[3]

(c) acquisition costs, in particular commissions, are similar to a pre-paid expense. Commissions constitute the most significant component of acquisition costs. If an insurer pays an agent a commission at the start of a contract's coverage period, but the policyholder lapses half-way through the coverage period, the insurer may have the right to recoup part of its commission expense from the agent. If the contract does not lapse, the insurer expects to recover the acquisition costs from the premiums. Recognising the acquisition costs and the premiums over the coverage and settlement period would be consistent with the view that a long-duration insurance contract is comprised of multiple one-year term contracts, and therefore, the upfront acquisition costs should be recognised in each of those one-year terms.

13. Agenda paper 2B/83B, appendix B discusses deferral of acquisition costs under existing US GAAP.

Why this presentation approach was previously rejected

14. In developing the IASB's 2007 DP, the IASB considered and rejected the view that the right to recover acquisition costs arose from a contract separate from the insurance contract, and rejected deferring acquisition costs and presenting the right to recover these costs as a separate asset. That approach was confirmed in developing the IASB's 2010 ED and the FASB's 2010 DP. The reasons for the boards doing so were as follows:

(so no release from risk), the transferee would want to receive CU94 to cover expected claims plus margin. The transferor would want to retain CU6 to cover its acquisition costs. So the parties would likely agree on a price of CU94. They might structure that price as either:

(a) single net price of CU94 or

(b) pass on full premium of CU100, less ceding commission of CU6.

However, in both cases, the insurer would seek to monetize the acquisition costs it had incurred.

[3] For example, suppose the following fact pattern: (i) an insurer sells a block of business with an expected present value of cash flows arising from the liabilities of CU90 (together with assets with a fair value of 100)); (ii) immediately before the sale, the selling insurer had under local GAAP measured the block of business at CU105, and had also recognised deferred acquisition costs of CU10; (iii) the purchaser receives CU90 for taking on that obligation (and pays CU100 for the assets). Under many existing GAAPs, the purchaser would recognise a liability of CU105 and an intangible asset of CU15. However, under alternatives A and B, the purchaser would recognise a liability of CU90 and no intangible asset.

(a) Recognizing a separate asset measured at the amount of acquisition costs incurred would overstate the insurer's liability and report as an asset a right that does not meet the definition of an asset in the framework:

   (i) The recovery of acquisition costs occurs either through cash flows that have already been received (in the case of a single premium received at inception) or through future cash flows incorporated in the measurement of the liability (in the case of recurring premiums received throughout the life of the contract).

   (ii) it is unclear what future economic benefits a separate asset that is measured at the amount of acquisition costs incurred would represent. In particular, the right to recover acquisition costs:

      (1) is an unsatisfactory representation of a customer relationship because it relates solely to benefits from the contract being measured, and not to possible future contracts with that customer

      (2) does not represent the value of the contract. The insurance contract liability already attempts to measure the value of the contract.

(b) The right to recover acquisition costs does not arise from a separate contract but arises as an inherent part of the insurance contract. The recognition of a separate asset for part of an insurance contract would require consideration of the method for amortising the asset in profit and loss, and whether the asset is impaired. However, because the right to recover acquisition costs is interrelated with the other cash flows that arises as the insurer fulfills the contract, the amortization and impairment of that right needs to consider those other cash flows. That suggests that the there is no difference between the cash flows recognized as an asset and those that are included in the measurement of the insurance contract liability. That observation is supported by current practice as follows:

   (i) in many jurisdictions today, the premium deficiency reserve test for non-life contracts or the liability adequacy test for life contracts (both impairment tests) test whether the present value of the expected future cash inflows will be sufficient to cover the present value of expected future cash outflows *and* the

recovery of the acquisition costs. If the test fails, the insurer first reduces the acquisition cost asset and then records a loss for any amount in excess of the acquisition costs.

(ii) under current accounting in most jurisdictions, the amortisation of the acquisition costs is typically based on the pattern that revenue is earned (i.e., amortized as estimated gross profits or margins are recognised for most life contracts and as premiums are earned for most non-life contracts).

(c) Recognizing a separate asset measured at the amount of acquisition costs incurred raises questions about whether the cash flows for recovering the acquisition costs are enforceable. Thus it is inconsistent with the boards' model for measuring the insurance contracts liability, which uses expected cash flows and does not distinguish between enforceable and non-enforceable components.

15. Accordingly, the staff thinks that an insurer should include acquisition costs in the cash flows used to determine the margin (and hence the insurance contract liability), rather than recognize the right to recover acquisition costs as an asset measured at the amount of acquisition costs incurred.

A comparison between two approaches that include acquisition costs in the cash flows used to determine the margin

16. Both alternatives B and C would include acquisition costs in the cash flows used to determine the margin and hence the insurance contract liability. However Alternatives B and C apply different conclusions to the questions of:

(a) Should changes in acquisition costs be shown as a component of the cash flows or the margin?

(b) When should the insurer recognise income/revenue for the part of the premium relating to acquisition costs?

(c) Should the margin (net of acquisition costs if applicable) be shown as a separate line item in the statement of financial position and should the release of the net margin be shown as a separate line item in the statement of comprehensive income?

17. The differences between Alternative B and Alternative C are shown in the following table:

	Alternative B	Alternative C
Where cash flows relating to the recovery of acquisition costs are shown	As a net against the margin, separately from other cash flows. In other words, the margin would be determined by excluding acquisition costs from the cash flows that arise as the insurer fulfils the contract. The acquisition costs would then be deducted from the margin.	Together with the other cash flows. In other words, the margin would be determined by including acquisition costs in the cash outflows that arise as the insurer fulfills the contract.
Recognition of revenue and expense	No revenue or expense would be recognized when acquisition costs are incurred. The margin, net of acquisition costs, would be allocated to profit or loss over the coverage period or settlement period using the pattern the boards have previously determined for the single/residual margin.	When acquisition costs are incurred.
Presentation in statements of comprehensive income and financial position	The margin, net of acquisition costs, would be required to be presented as a separate line item. In addition, the change in net margin would be disclosed as part of the reconciliation of contract balances disclosure proposed in the ED.	No separate line item[4]. The change in cash flows would be disclosed as part of the reconciliation of contract balances disclosure proposed in the ED.

18. This paper discusses Alternatives B and C as an integrated group of related decisions.

[4] Subject to requirement in IAS 1 *Presentation of Financial Statements* to disclose line items relevant to an understanding of the entity's financial position.

19. We illustrate the difference between Alternatives B and C in paragraphs 20-24 as follows. This is based on the example in the Appendix, which sets out all the relevant journal entries.

20. Before the premiums are received and immediately before any acquisition costs are incurred, the insurer would recognise[5] the following amounts:

T0	**Alternative B: Acquisition costs netted against margin**	**Alternative C: Acquisition costs included in cash flows**
Future cash inflows	**(12,000)**	**(12,000)**
Less future cash outflows	**8,400**	**8,400**
Less future acquisition costs	**-**	**1,200**
Total future cash outflows	**(3,600)**	**(2,400)**
Margin to eliminate gain at inception	**3,600**[6]	**2,400**
Carrying amount	**0**	**0**

21. At T1, the acquisition costs have been incurred. In Alternative C income and expense of 1200 would be recognised, and there would be no effect in the statement of financial position. In alternative B, the acquisition costs are netted against the margin as follows:

T1	**Alternative B: Acquisition costs netted against margin**	**Alternative C: Acquisition costs included in cash flows**
Margin at inception	**3,600**	**2,400**
Acquisition costs incurred	**(1,200)**	**-**
Net margin	**2,400**	**2,400**

22. The release of the (net) margin would be amortised over time, ie CU20 per period in both Alternative B and Alternative C. However, in Alternative C, revenue and expense are recognised when acquisition costs are incurred. In Alternative B, no revenue or expense is recognised and the amount of premium recognised over the

[5] At the 15 March 2011 joint board meeting, the boards tentatively decided that the insurer should not recognise the contract until the coverage period begins. For convenience, this example assumes that the coverage period begins immediately before any acquisition costs are incurred. The treatment of acquisition costs in the precoverage period is discussed in agenda paper 2D/83D.

[6] This amount includes the future acquisition costs of CU1,200 and the margin of CU2,400.

coverage or settlement periods is the total premium charged to the policyholder less the acquisition costs. This means that the amount recognised as premium in Alternative B over the coverage or settlement periods is less than the amount of premium recognised in Alternative C.

23. Thus, the carrying amount at T1 is:

T1	**Alternative B: Acquisition costs netted against margin**	**Alternative C: Acquisition costs included in cash flows**
Future cash inflows	**(12,000)**	**(12,000)**
Less future cash outflows	**8,400**	**8,400**
Total future cash outflows	**(3,600)**	**(3,600)**
Net margin	**2,400**	**2,400**
Carrying amount	**(1,200)**	**(1,200)**

24. When the premium is paid, CU12,000 is received and the carrying amount of the insurance contract liability becomes CU10,800 in both alternatives B and C.[7]

25. Thus, the measurement of the insurance contract liability as a whole would be the same in both alternatives B and C. However, the alternatives differ as follows:

(a) Before the acquisition costs occur, there is a difference in the split between the remaining margin and the fulfilment cash flows.

(b) After acquisition costs occur, there would be no difference in the statement of financial position. This means that there would be no difference between Alternative B and Alternative C if the acquisition costs are incurred at initial recognition.

(c) The acquisition costs will be shown in the roll forward of the margin in Alternative B and in the roll forward of the cash flows in Alternative C.

(d) Alternative B does not recognise revenue or expense when acquisition costs are incurred. Only the premium less the acquisition costs, and not the premium as a whole, is recognised over time.

[7] For comparison, if the acquisition costs were to be accounted for as a separate asset as in Alternative C, the insurer would recognise an insurance contract liability of CU12,000 and an acquisition cost asset of CU1,200.

Alternative C recognizes premium income when acquisition costs are incurred (often at inception), leaving less income to recognize over time. Arguments in favour of Alternative B

Acquisition costs are economically different from fulfilment cash flows related to the benefit obligation

26. Those who support Alternative B regard the cash flows relating to policyholder claims and benefits as economically different from the cash flows relating to the recovery of acquisition costs and the margin.[8] Those with this view see a distinction between the expenses which the insurer incurs to settle its insurance liabilities, (e.g. fulfil its obligation to pay benefits to policyholders and pay any expenses to settle a claim, which are often paid to an entity other than the policyholder) and the expenses which the insurer incurs to obtain a contract (e.g. acquisition costs).

27. Similarly, some think of the margin as different from the other components of the insurance contract liability because it does not relate to the expected claims and benefits payments. However, they believe that changes in acquisition costs do impact the profit the insurer expects to make, and therefore that it would be appropriate to net them in the margin. As a result, some find it more intuitive to think of the acquisition costs as reducing the margin, and thus the expected profit from the contract, rather than as part of the expected cash flows to fulfil the insurer's obligation to the policyholder.

28. In addition, those with this view note that treating acquisition costs in the same way as other contract cash flows would require a change to existing accounting by insurers because:

    (a) Insurers typically estimate the unbiased probability-weighted estimate of expected cash flows using stochastic modelling based on various assumptions and scenarios (i.e., mortality and lapse assumptions). In such models, insurers do not measure the acquisition costs arising under the contract on a probability-weighted basis. Rather, the amount is typically fixed or determined based on the probability-weighted estimates of the premium, for example as a percentage of a probability-weighted premium. However, the acquisition costs for trail commissions may vary based on the probability-

[8] Although acquisition costs can be recovered in different ways through the premium (through the policyholder or a third party), as noted in agenda paper 2B/83B, this does not demonstrate that they are economically similar to the insurance obligation cash flows under the contract.

weighted amount of premium. Therefore, some think that the acquisition costs should not impact the probability-weighted estimate of cash flows needed to fulfil the contract and therefore should not be presented with the cash flows that are probability-weighted. For non-life insurance contracts, acquisition costs, including any additional commissions, are not included in the calculation of the unbiased probability-weighted estimate of expected cash flows.

(b) Users of financial statements do not typically include acquisition costs in their analysis of an insurer's core business (e.g., underwriting). However, they are interested in the amount of acquisition costs incurred by an insurer[9]. Some users have indicated that they compare acquisition costs incurred relative to the number of new contracts in-force as an efficiency measure, i.e. how well the insurer converts dollars spent on acquisition costs into new contracts over time.

(c) In most jurisdictions, today's accounting measures the insurance contract liability using the insurer's best estimate liability, excluding acquisition costs. That means there is an implicit margin net of acquisition costs. However, because the building block approach would measure the insurance contract liability using the present value of fulfilment cash flows, an explicit margin is required to avoid a day 1 gain.

Presentation as separate line item

29. Those that support Alternative B are concerned that, if changes in all the building block components are combined in a single line item, it will be difficult for users to determine whether the insurer changed assumptions which impact their obligation to fulfil the contract through the payment of claims and benefits, or if the movement was simply from the payment of acquisition costs and/or release of margin.

30. Because Alternative B would present, in the statement of financial position, the insurer's obligation to the policyholder to fulfil the insurance contract (including the benefit payments and expenses) separately from the margin net of acquisition costs, it

[9] For life business, acquisition costs are often expressed as a percentage of earned premium and referred to as the acquisition cost ratio (sometimes separately for commissions and generally separately for renewal and single premium). For non-life business, acquisition costs relative to unearned premium reserves (e.g., liability for remaining coverage) is a key performance indicator.

would more clearly present changes in the insurer's assumptions about its obligations to fulfil the contract, i.e. the liability would be driven by changes in insurer's benefit obligation. Some are concerned that if all building block components are combined, it will be difficult for users to determine whether the insurer changed assumptions which impact their cash flows obligation to fulfil the contract, or if the movement was simply from the payment of acquisition costs and/or release of margin.

31. Likewise, in the statement of comprehensive income, those who support Alternative B believe it would offer greater transparency because it would show the effect of the margin net of acquisition costs separately from the cash flows needed to pay policyholder claims and benefits. They also argue that this would better reflect the results of an insurer's core operations. In contrast, Alternative C provides this information in a disclosure, as opposed to on the statement of comprehensive income.

Recognition of premium charged to cover acquisition costs over the coverage period or settlement period using the boards' tentative decisions on the pattern used to release the margin

32. Alternative B would recognise the margin net of acquisition costs over the coverage period or settlement period using the pattern the boards have previously determined for the single/residual margin. The reasons for those supporting this view are as follows:

    (a) Simply paying or incurring acquisition costs should not trigger revenue recognition because it does not relate to the performance of the insurance obligation. The policyholder receives no benefit from the acquisition costs component of the premium amount, and views the insurance contract based on the value they expect to receive (transfer of risk under the contract) for the premiums they have paid or will pay. Therefore, the payment (or incurring) of acquisition costs is not the satisfaction of a performance obligation applying the revenue recognition model.

    (b) In addition to the inconsistency with the current proposals in revenue recognition noted in (a), the recognition of revenue related to the recovery of acquisition costs over time would lead to consistent results with the approach in 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. Under each of these models, qualifying acquisition costs would be recognized as an asset (or included in an asset balance) on the statement of financial position and subsequently amortized. Agenda paper 2B/83B, Appendix A provides excerpts from the relevant guidance.

(c) One result of Alternative C is that insurers that incur greater acquisition costs recognize more revenue when they incur those costs than those who incur lower acquisition costs. This could incentivize insurers to consider classifying more costs as acquisition costs to inflate the premium they can recognize as revenue earlier (at inception for most acquisition costs, as described above).

33. One consequence of Alternative B is that the insurer does not recognise the full amount of the premium charged over the coverage or settlement periods. This is because the margin net of acquisition costs is recognised in profit or loss. Therefore, the total amount of premium recognised is the total amount of premium charged to the policyholder less acquisition costs. This arises in part from having acquisition costs as a net against the margin, separately from other cash flows, and in part due to the difficulty related to tracking the acquisition costs separately from the margin after day 1. However, assuming that acquisition costs are amortised in proportion to the margin, the amount recognised in the statement of comprehensive income for the amortisation of the net margin would be similar to the net amount that would be recognised if the insurer had recognised the amortisation of the gross margin and amortisation of a separate acquisition cost asset. Amortising the acquisition costs in proportion to the revenue earned would be consistent with the revenue recognition ED and current US GAAP[10].

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[10] Paragraph 98 of the revenue recognition ED requires that an asset recognised when an entity expects to recover the incremental costs of obtaining a contract with a customer should be amortised on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates.
Under US GAAP, contracts applying former FAS 60 model, which uses locked-in assumptions, deferred acquisition costs are amortized over time proportional to premiums recognised in the statement of comprehensive income. For interest sensitive contracts where only the account balance is recorded in the statement of financial position and premiums are not recognized in the statement of comprehensive income, the amortisation of deferred acquisition costs is based on a contract's estimated gross profit, or based on a contract's estimated gross margin using retrospective catch-up method. "Retrospective catch up" means that estimates of expected gross profits used as a basis for amortization should be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to earnings if actual experience or other evidence suggests that earlier estimates should be revised.

34. Those who support Alternative B believe that amortising one net amount avoids the determination of an amortisation pattern for a separate acquisition costs asset, and a method of impairment for that asset, as discussed in paragraphs 12 through 14 above. However, the amount of acquisition costs not yet recognised in the statement of comprehensive income (and the amount recognised each period) would not be available to users of the financial statements. Most users are interested in the amount of acquisition costs incurred or paid for the premium written, thus indicating how efficiently the insurer is using their cash flows. If the boards would like to require tracking the amount of acquisition costs not yet recognised in the statement of comprehensive income, insurers could potentially track the components of the margin separately or determine acquisition costs as a percentage of the margin on day 1, and apply that percentage in subsequent years for disclosure purposes. However, this could present operational complexity as the insurer would have to track the percentage of acquisition costs to the margin, and then gross up that amount every period which would be further complicated when new blocks of business are added to the portfolio. This could most likely be achieved in a locked environment where the amortisation pattern is updated on a prospective basis, however, in an unlocked environment, it would be nearly impossible to track the percentage of acquisition costs to the margin that is updated based on changes in expectations.

35. While not recognising the full premium as ultimate revenue and the potential complexities in tracking the acquisition costs that are recognised each period (and those not yet recognised), supporters of Alternative B believe that this approach is still preferable to recognising premium equal to or offsetting the acquisition costs as they are incurred, the majority of which are incurred at the inception of the contract.

36. As a result, the FASB staff support Alternative B.

Arguments in favour of Alternative C

The insurance contract liability is a measure of all the obligations in a contract and it is arbitrary to separate components

37. 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 and does not distinguish between cash flows on the basis of the reason that they occur or on the basis of who the counterparty is. The key advantage of the insurance

contracts model is that it is not necessary to make distinctions which may not reflect economic differences. For example Agenda paper 2B/83B describes a number of ways in which an insurer can structure the acquisition costs it pays to ensure that it recovers those costs. That shows that acquisition costs that are not recovered from premiums received at inception can, in some cases, be recovered from the agent (for commissions), or through paying a policyholder a lower benefit on an early lapse (ie by applying a surrender charge) and in some cases, the ability for the insurer to recover such acquisition costs can be dependent on lapse rates. Because there is little economic difference arising from the different ways that an insurer can recover acquisition costs, some believe that a key advantage of treating all of the cash flows in the same way is that it would apply the same treatment (probability-weighted basis) to all lapse dependent cash flows. 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.

Presentation as separate line item

38. Additionally, some believe that the margin is an inherent part of the insurance contract. In a locked approach, it represents an estimate of the return (beyond the return for bearing risk in the case of the IASB) that the insurer demanded for providing its services, including the amount required to cover indirect costs. In an unlocked approach, it represents the unearned profit in the contract. In either case, it does not exist outside the contract and is an integral part of the liability and not a standalone liability. Some argue that it would be misleading to present a line item that does not provide a meaningful representation of a free-standing liability. Therefore, those supporting Alternative C think that there should be no requirement for insurers to disaggregate in the statement of financial position the amount of the margin from the other components of the insurance contract liability.

39. Similarly, those supporting Alternative C think that while information about the release of the margin in the statement of comprehensive income could provide useful information about the change in the insurance contract liability, that information is just one part of the change in the insurance contract liability overall.

40. Therefore, although those supporting Alternative C do not favour *requiring* insurer to present the margin as a separate line item on the statement of financial position and the release of the margin as a separate line item in the comprehensive income, they agree that the disaggregation of such information, as in the way proposed in the disclosures section of the ED, can provide useful information[11].

Recognition of premium charged for acquisition costs when acquisition costs are incurred

41. In Alternative C, insurers would expense acquisition costs and recognise income to cover those costs when the acquisition costs are incurred. That view is consistent with the view that part of the premium received is compensation for acquisition costs incurred or to be incurred, and not compensation for the insurance obligation itself. Thus, measuring the insurance contracts liability initially at the amount of total premium received without eliminating the amount of premium charged to cover acquisition costs would not represent faithfully the remaining obligations the insurer has to fulfill the contract. Alternative C ensures that the measurement at inception should not be different for two insurance obligations that have identical contractual terms, 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. (Supporters of Alternative C assume that identical obligations should be measured at the same amount, and that if the insurer charges a different margin to take on the same obligation (for example for competitive or other reasons) the contracts are no longer identical and thus we would not expect the obligation to be measured identically.)

42. Furthermore, the staff note that:

    (a) A key argument against Alternative C is the proposal that premium income is recognised when acquisition costs are incurred is inconsistent with the proposals in the revenue recognition ED. However, Alternative B is also inconsistent with the revenue recognition ED because it would not recognise

[11] In addition, the IASB staff notes that IAS 1 requires insurers to present additional line items showing information important in their circumstances. The staff notes that we plan to review the line items on the financial statements as a whole in a future meeting.

the full amount of the customer consideration over the coverage and settlement periods.[12]

(b) Should the boards agree with Alternative C except on the issue of when revenue is recognized, it would be possible to modify Alternative C so that an insurer accounts for and presents 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. However, this could present some operational complexity.

Question 1: Rejection of a deferred acquisition cost asset
Do the boards agree that an insurer should include acquisition costs in the cash flows used to determine the margin (and hence the insurance contract liability),, (ie either Alternatives B or C) rather than recognize the right to recover acquisition costs as an asset measured at the amount of acquisition costs incurred (Alternative A)?

Question 2: Acquisition costs in the building block approach
Do the boards think that an insurer should: (a) recognise a reduction in the margin when the acquisition costs are incurred, with no effect in the statement of comprehensive income. The acquisition costs would be shown net against the residual/single margin and allocated to profit or loss using the allocation pattern the boards have previously determined for the single/residual margin *(Alternative B).* or (b) account for 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, and recognize premium *income* equal to, and offsetting, those costs when the acquisition costs are incurred (*Alternative C).*

[12] The staff notes that if the boards adopted Alternative B, they could require insurers to track the percentage of acquisition costs to the margin, and then gross up that amount every period. However, as noted in paragraph 34, this could present operational complexity.

Appendix: journal entries comparing the three alternatives

Example: A Single premium contract

A1. On 1 January 20x0, an insurer issues a large number of life insurance contracts with the following features:

(a) Policyholders pay a premium of CU12,000 in aggregate on 1 January

(b) The contracts are in force until 31 December 20X9. Over the ten year life of the contracts, the expected death benefits are CU8,400. No deaths are expected to occur in the first year of the contract.

(c) For simplicity, the time value of money and risk adjustment are ignored.

(d) The insurer incurs acquisition costs of CU1,200 on 1 January 20x0. There are no other expenses.

(e) The contracts have no surrender value

(f) The contract provides an implicit margin of CU2,400 (premiums of CU12,000 less death benefits of CU8,400 less acquisition costs of CU1,200).

(g) The release of the margin is assumed to be constant over the life of the contract, therefore CU20 per month.[13]

A2. There are no changes in estimates during the period covered by the example.

[13] In other words, for the IASB, assume that the pattern of services used to allocate the residual margin is constant, for the FASB, assume that the release from risk is constant.

A3. The following journal entries illustrate the accounting in the following alternatives:

Building block approach	**Alternative A**		**Alternative B**		**Alternative C**	
At inception of the contract (day 0)						
Dr. insurance liability – expected cash inflows[14]	12,000		12,000		12,000	
Cr. insurance liability- Expected cash outflows		8,400		8,400		8,400
Cr. insurance liability- Expected acquisition costs				1,200		1,200
Cr. insurance liability – Margin		3,600		2,400		2,400
NOTE: The model presents these amounts as a single net insurance contract liability, consistent with the view that they arise from a single contract. Accordingly the insurance contract liability at that point in time is nil.						
When acquisition costs are incurred (at inception of the contract) [15]						
Dr. insurance liability – expected acquisition costs					1,200	
Cr. Revenue/income						1,200
Dr. insurance liability – expected acquisition costs			1,200			
Cr. Acquisition costs expense				1,200		
Dr. Acquisition costs asset	1,200					
Cr. Acquisition costs expense		1,200				
Dr acquisition costs expense	1,200		1,200		1,200	
Cr acquisition costs liability (payable)		1,200		1,200		1,200

[14] CU12,000 represents the total premium charged and includes expected inflows of CU8,400 as part of the premium it charges to cover benefits and expenses, expected inflows of CU1,200 as part of the premium it charges to cover recovery of acquisition costs and expected inflows of CU2,400 that it expects will be profit.

[15] We note that the majority of acquisition costs are incurred at inception of the contract but the recovery of costs may not occur at inception. For many recurring premium life contracts, the recovery of the acquisition costs may occur over the contract term.

When acquisition costs are paid								
Dr acquisition costs liability (payable)		1,200			1,200		1,200	
Cr. Cash			1,200			1,200		1,200
When some revenue is earned one month thereafter: Suppose the only change is in the amortisation of the margin and acquisition cost asset. In a 10-year contract with straight line amortization pattern, the amortisation after the first month is the amount of the margin or acquisition cost asset divided by 120 months.								
Dr. insurance contract liability - margin		30			20		20	
Cr. Revenue - Release of margin			30			20		20
Dr acquisition costs expense		10						
Cr Acquisition costs asset			10					