STAFF PAPER

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Project	**Insurance contracts**
Paper topic	Acquisition costs in the premium allocation approach

CONTACT(S)	Andrea Pryde	apryde@ifrs.org	+44 (0) 20 7246 6491
	Lauren Alexander	lalexander@fasb.org	+1 203 956 3468
	Jennifer Weiner	jmweiner@fasb.org	+1 203 956 5305

Purpose of this paper

1. This paper considers the accounting for acquisition costs in the premium allocation approach. It builds on, and should be read with, Agenda papers 2B/83B and 2C/83C.

Staff recommendations

2. The FASB staff recommends that, consistent with the IASB's ED, an insurer should, in accounting for acquisition costs:
   (a) recognise the liability for remaining coverage net of acquisition costs (consistent with the tentative decision from February 2012 joint board meeting).
   (b) recognize acquisition costs as an expense and premium, gross of the amortisation of acquisition costs, according to the pattern confirmed by the boards in April 2011. The amortisation of acquisition costs (according to the same pattern) should be shown separately.
3. The IASB staff recommends, consistent with its recommendation in agenda paper 2C/83C, that an insurer should, in accounting for acquisition costs:
   (a) recognise the liability for remaining coverage net of acquisition costs (consistent

with the tentative decision from February 2012 joint board meeting).

(b) expense acquisition costs when incurred and at the same time recognize premium income equal to, and offsetting those acquisition costs.

(c) recognise the remaining premium according to the pattern confirmed by the boards in April 2011.[1]

Staff analysis

4. As noted in agenda paper 2B/83B, the IASB's ED[2] had an inconsistency between measurement and presentation in the premium allocation approach in which:

(a) The measurement of the insurance contract liability was consistent with the building block approach. In other words, there was no separate asset recognised and the measurement of the liability excluded the amount of premium from which the insurer expects to recover acquisition costs; and

(b) The presentation in profit and loss was consistent with the approach in the revenue recognition model. In other words the premium, including premium charged to cover acquisition costs, was recognised as revenue over the coverage period. This lead to the effect that acquisition costs are 'amortised' over the coverage period, even though no separate asset was recognised.

5. This resulted in the same pattern of recognition of premium revenue and amortisation cost expense as would arise if the acquisition costs had been recognised as an asset. Thus, it is consistent with the recognition pattern in most jurisdictions today[3].

6. Both the IASB and the FASB indicated at a previous meeting that they would prefer to

[1] ie, 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. This pattern of recognition was proposed in the ED and confirmed in April 2011.

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

[3] At the February 27, 2012 joint meeting, the boards tentatively decided that the time value of money should be required in measuring the liability for remaining coverage for contracts that have a significant financing component, unless 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.

have consistency in the treatment of acquisition costs between the building block approach and the premium allocation approach.

7. In the premium allocation approach, the margin is not identified separately, but implicit in the liability for remaining coverage. Therefore, if one were to apply the staff recommendations in agenda paper 2C/83C to the premium allocation approach, this would imply the following:

   (a) In alternative B[4]:

      (i) Recognise the liability for remaining coverage at the amount of the premium less the expected acquisition costs

      (ii) Recognise a reduction in the liability for remaining coverage when the acquisition costs are incurred, with no effect in the statement of comprehensive income

      (iii) Present the liability for remaining coverage net of acquisition costs. That net amount would be allocated to profit or loss using the allocation pattern the boards have previously determined for the margin.

   However, the staff that supported Alternative B in agenda paper 2C/83C propose that in the premium allocation approach the premium would be gross of acquisition costs, rather than net of acquisition costs as proposed in agenda paper 2C/83C for the building block approach. This is discussed in paragraph 13.

   (b) In alternative C, the insurer would:

      (i) Recognise the liability for remaining coverage at the amount of the premium less the expected acquisition costs

      (ii) Recognize premium income equal to, and offsetting incurred acquisition costs and expense acquisition costs when incurred.

8. Agenda paper 2C/83C also discussed the presentation of the margin as a separate line item. However, as the margin is implicit rather than explicit in the premium allocation approach and the boards have already tentatively decided that the liability for remaining coverage should be presented as a separate line item from the liability for incurred

[4] For ease of comparison with Agenda paper 2C/83C, Alternative B and Alternative C are, except as discussed, consistent with Alternatives B and C in agenda paper 2C/83C.

claims, this paper does not address presentation in the premium allocation approach

9. The following example illustrates the staff proposals for Alternatives B and C in the premium allocation approach. In addition, we show for comparison, as Alternative A, an approach in which the insurer recognises acquisition costs as an asset.[5]

Example

10. Assume acquisition costs, paid at inception, of 15 percent of the premium of CU1,200, ie CU180. Assume also an 80 percent loss ratio. This would result in the following entries at day 0, inception and at the end of the first quarter:

Premium allocation approach example	Alternative A		Alternative B		Alternative C	
<u>*At contract initiation (day 0)*</u>						
Dr. Receivable or Cash	*1,200*		*1,200*		*1,200*	
Cr. Liability for remaining coverage		*1,200*		*1,200*		*1,200*
NOTE: In Alternatives B and C, the liability for remaining coverage implicitly comprises expected cash outflows of 960, acquisition costs of 180, and margin of 60. In Alternative A, the liability for remaining coverage implicitly comprises expected cash outflows of 960 and margin of 240.						

[5] As with agenda paper 2B/83B, the staff does not consider in this paper the alternative of both excluding acquisition costs from the expected cash flows to fulfill the contract and expensing all acquisition costs when incurred. That approach had been rejected by both boards in previous discussions.

Premium allocation approach example	**Alternative A**		**Alternative B**		**Alternative C**	
When acquisition costs are incurred (at inception of the contract)						
Dr. Acquisition cost expense (commissions, payroll, etc.)	*180*		*180*		*180*	
Cr. Acquisition costs liability (payable)		*180*		*180*		*180*
Dr. liability for remaining coverage					*180*	
Cr. earned premium						*180*
Dr. Liability for remaining coverage			*180*			
Cr. Acquisition cost expense				*180*		
Dr. Acquisition cost asset	*180*					
Cr. Acquisition cost expense		*180*				

Premium allocation approach example	**Alternative A**		**Alternative B**		**Alternative C**	
<u>*When acquisition costs are paid*</u>						
Dr. Acquisition cost liability (payable)	*180*		*180*		*180*	
Cr. Cash		*180*		*180*		*180*
<u>*When revenue is earned each quarter thereafter:*</u>						
Dr. Liability for remaining coverage	*300*		*255*		*255*	
Dr. Amortization of acquisition costs (expense)			*45*			
Cr. Earned premium		*300*		*300*		*255*
Dr. Amortization of acquisition costs (expense)	*45*					
Cr. Acquisition costs asset		*45*				
Dr Claims expense	*240*		*240*		*240*	
Cr Liability for incurred claims		*240*		*240*		*240*

Alternative B

11. The staff that supported Alternative B in agenda paper 2C/83C propose a variant of that approach for the premium allocation approach. The similarities and differences between Alternative B for the premium allocation approach and Alternative B in the building block approach are summarised in the following table[6].

[6] Agenda paper 2C/83C also discussed the presentation of the margin as a separate line item. However, as the margin is implicit rather than explicit in the premium allocation approach and the boards have already tentatively decided that the liability for remaining coverage should be presented as a separate line item from the liability for incurred claims, this paper does not address presentation in the premium allocation approach.

	Alternative B for the premium allocation approach (this paper)	Alternative B for the building block approach (agenda paper 2C/83C)	The approach in the IASB's ED
Where cash outflows relating to acquisition costs are shown	As a net against the liability for remaining coverage	As a net against the margin, separately from other cash flows[7]	As a net against the liability for remaining coverage
Recognition of revenue and expense	• Premium[8]: Recognize over the coverage period according to the boards' tentative decisions • Acquisition costs: show expense separately as if acquisition costs amortised over coverage period	• Premium less acquisition costs: Recognise through allocation of margin according to boards' tentative decisions for BBA[9] • Acquisition costs: Do not recognise as expense	• Premiums: Recognize over the coverage period according to the boards' tentative decisions • Acquisition costs: show expense separately as if acquisition costs amortised over coverage period

12. Alternative B has the following features:

(a) It would result in the same *pattern* of recognition of premium revenue that would arise if the acquisition costs had been recognised as an asset (Alternative A), as in the approach proposed in the IASB's ED and in Alternative B in the building block approach (in agenda paper 2C/83C).

[7] Under the building block approach, the margin is explicitly determined, and acquisition costs reduce that margin as opposed to the premium allocation approach, where a margin is not explicitly determined but included implicitly in the liability for remaining coverage.

[8] In the premium allocation approach the premium would be gross of acquisition costs. In the building block approach the premium would be net of acquisition costs.

[9] The boards plan to discuss whether to allocate premiums as premiums earned to the statement of comprehensive income over the coverage period.

(b) It would result in the same *amount* of premium revenue recognised over the contract term as if the acquisition costs had been recognised as an asset (Alternative A) and as in the approach proposed in the IASB's ED (ie it would recognise acquisition costs as an expense and premium 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). However, it would result in the recognition of the full amount of premium charged as revenue, unlike Alternative B in the building block approach (in agenda paper 2C/83C).

(c) It is consistent with the approach proposed in the IASB's ED and with Alternative B in agenda paper 2C/83C because it measures the liability for remaining coverage net of the acquisition costs. The liability for remaining coverage is reduced and premiums are recognised over the coverage period according to the boards' tentative decisions. Because the margin, although not explicitly determined, is implicit in the liability for remaining coverage, it likewise is reduced and earned in the same manner.

13. The staff note that the amount of premium revenue recognised over the coverage/settlement period would be gross of acquisition costs in Alternative B in the premium allocation approach and net of acquisition costs in Alternative B in the building block approach. However, the staff supporting Alternative B believe it is appropriate for the premium allocation approach to (1) gross up the premium and (2) record the liability of remaining coverage net of acquisition costs for the following reasons:

(a) Earned premium is a key performance indicator and is part of another key performance indicator, loss ratio. These indicators tell the users how well the insurer priced its business for its obligation to the policyholder (i.e., its core operations). Users are also interested in the amount of acquisition costs incurred for the premium earned to determine how efficient the insurer is in obtaining business.

(b) Users look to the liability for remaining coverage to identify insurers' growth but not to determine changes in assumptions. This is because contracts that meet the board's proposed criteria to apply the premium allocation approach would be those where it is unlikely that there will be a significant change in the expectations of net cash flows required to fulfill the contract during the period before the claim is incurred. As a result, splitting the implicit margin, net of acquisition costs, from the remainder of the liability for remaining coverage does not provide users with additional information. Changes in assumptions are reflected in the liability for incurred claims and are transparent to the user because the boards have already tentatively decided to present the liability for remaining coverage separate from the liability for incurred claims. In contrast, for most contracts that will be accounted for using the building block approach, changes in assumptions occur prior to the claim being incurred (subsequent to the event occurring there is typically minimal to no movement in the amount of the incurred loss). Therefore, splitting the liability for those contracts into components for the expected cash flows to fulfil the obligation to the policyholder (which most likely will change prior to the claim being incurred), and the margin, net of the acquisition costs (which will be amortised based on the boards' tentative decisions) makes the changes in assumptions more transparent to users.

(c) There is little operational complexity in grossing up the premiums earned for the premium allocation approach, whereas it is more complex for the building block approach, as discussed in agenda paper 2C/83C.

14. The staff supporting Alternative B also note two consequences if the boards were to apply Alternative C.

15. First, if the policyholder lapses after the first quarter, Alternatives B and C would both show a liability for remaining coverage net of acquisition costs of CU765[10]. (Alternative A would show a liability for remaining coverage of CU900[11].) In the case of a lapse, for most non-life contracts[12], the insurer is required to pay the policyholder the premium for

[10] Premium of CU1200 less acquisition costs of CU180 less earned premium of CU255.
[11] Premium of CU1200 less earned premium of CU300.
[12] This is in contrast to typical life contracts, in the case of a lapse, where there is either a build up of the cash surrender value or explicit surrender charges deducted from an account value, both of which considers recovery of acquisition costs at each point in time a policyholder may surrender their contract; as the insurer recovers their acquisition costs the surrender charge (implicit or explicit) is reduced to zero.

the unexpired insured coverage period, in this case CU900[13].

16. In Alternative C, if policyholder lapses during the contract term exceed previous estimates, such a lapse might lead to negative earned premium and negative expense amount. However, in Alternative B, the insurer has not recognised premium revenue or expense, so it is not necessary for it to reverse any entries in the statement of comprehensive income in the event of a lapse. Said differently, the mechanics in Alternative B are essentially operating as a contra-liability because no amounts have yet been recognised in the statement of comprehensive income and it is possible to unwind without reversing entries there. On the other hand, in Alternative C, the insurer has earned the amount of premium related to the acquisition costs at inception and recognised a corresponding expense for that amount. Therefore, to reverse the impact and refund the policyholder, an insurer would require a negative earned premium amount and a corresponding offset to negate the expense.

17. Second, some may believe that the results may be misleading, specifically with regard to calculating key performance indicators. Most insurers with contracts within the scope of the premium allocation approach record the liability for incurred claims based on a loss ratio (percentage of expected losses to premiums). The difference between (a) this calculated balance and (b) the actual claims reported is considered IBNR (incurred but not reported claims). In the example above, the insurer's expected 80 percent loss ratio results in CU 960 of liability incurred and a profit of CU240, CU180 of which is paid for acquisition costs. Users analyze whether the loss ratio (loss and loss adjustment expenses divided by earned premiums) increases or decreases and reasons for such changes each period. If premiums are recognised as revenue when acquisition costs are incurred, which is typically at the initial recognition of the contract, the amounts reported in the period suggest that the liability for incurred claims is recorded at a loss ratio of approximately 95 percent (CU240 divided by CU 255). In fact the insurer's unbiased probability weighted estimate of expected cash flows would indicate it should be an 80 percent loss ratio instead.

18. In addition, because the premium for the recovery of acquisition costs is recognized at inception of the contract in this example, the earned premium related to incurred losses

[13] ie ¾ of the premium paid by the policyholder of CU1200

in that period would not be available in the footnote disclosures for users to calculate loss ratios. Similar to analysis of life insurance, while users are interested in the amount of acquisition costs for the amount of premium written or earned, they do not include in their analysis costs that are not related to the payment of claims or the expenses to fulfil that obligation (i.e., acquisition costs, overhead costs, etc.). Instead users are interested in the insurer's underwriting performance (e.g., based on its core operations for life contracts).[14]

19. For these reasons as well as the reasons for recommending Alternative B in the building block approach in Agenda paper 2C/83C, the FASB staff recommend that insurers should:

   (a) recognize the liability for remaining coverage net of acquisition costs (tentative decision from February 2012 joint board meeting)

   (b) recognize acquisition costs as an expense and premium, gross of the amortisation of acquisition costs, according to the pattern confirmed by the boards in April 2011. The amortization of acquisition costs (according to the same pattern) should be shown separately.

[14] Some staff believe that insurers and users would adjust key performance indicators in the light of any accounting changes. For example, they would revise loss ratios so that these ratios would include acquisition costs if that would result in comparability across industries, even if this is not calculated in the same manner as under today's GAAP. Those staff believe the financial statements would provide the information needed to calculate these revised ratios.

Alternative C

20. The similarities and differences between Alternative C for the premium allocation approach and Alternative C in the building block approach are summarised in the following table[15].

	Alternative C for the premium allocation approach (this paper)	Alternative C for the building block approach (agenda paper 2C/83C)	The approach in the IASB's ED
Where cash outflows relating to acquisition costs are shown	As a net against the liability for remaining coverage.	In the cash flows used to determine the margin[16]	As a net against the liability for remaining coverage
Recognition of revenue and expense	• Premium related to acquisition costs: Recognise as revenue when acquisition costs are incurred. • Remaining premium: Recognise over coverage period • Acquisition costs: Recognise expense when acquisition costs are incurred.	• Premium related to acquisition costs: Recognise as revenue when acquisition costs are incurred. • Remaining premium: Recognise over coverage period • Acquisition costs: Recognise expense when acquisition costs are incurred.	• Premium related to acquisition costs: Recognize over the coverage period. • Remaining premium: Recognise over coverage period. • Acquisition costs: show expense separately as if acquisition costs amortised over coverage period

[15] We plan to discuss presentation in the premium allocation approach in a future meeting.

[16] Under the premium allocation approach, the present value of fulfilment cash flows relating to remaining coverage and the margin are combined in the liability for remaining coverage. Thus there would be no difference between showing cash outflows relating to acquisition costs in the margin and showing them in the cash flows.

21. Alternative C has the following features:

    (a) It would recognise the premium, net of acquisition costs, over the coverage period. Thus, it would result in the same amount of premium revenue recognised over the contract term[17] as in Alternative C in the building block approach (agenda paper 2C/83C). It would result in a different amount of premium revenue recognised over the contract term than if the acquisition costs had been recognised as an asset (Alternative A) or than in the approach proposed in the IASB's ED.

    (b) It is consistent with the approach proposed in the IASB's ED and with Alternative C in agenda paper 2C/83C because it measures the liability for remaining coverage net of the acquisition costs. The margin for the premium allocation approach is implicit in the liability for remaining coverage.

22. For the IASB, its tentative decision that the premium allocation approach should be used only when it is a proxy to the building block approach suggests that different treatment of acquisition costs in the building block approach and the premium allocation approach cannot be justified. (As a result, if the boards do not accept the IASB's staff recommendation in agenda paper 2C/83C, the IASB staff's recommendation in this paper would also change.)

23. In addition, in response to the concern expressed in paragraph 17, some disagree that the results would be misleading. Although Alternative C would present information in a different way and that would affect the key performance indicators used today, some argue that the information given by doing so provides a more useful indicator of overall profitability and of how well the insurer priced its business overall because it includes the acquisition costs in determining the overall profitability. This is the information that would be of ultimate interest to the investor.

24. Accordingly, the IASB staff recommend that, consistent with their recommendation for the building block approach, insurers should

    (a) recognize the part of the premium that recovers acquisition costs as income when

[17] The boards will be discussing at a future meeting the recognition (i.e., allocation) of premium as revenue in the statement of comprehensive income.

the acquisition costs are incurred

(b) recognize the remaining premium according to the pattern confirmed by the boards in April 2011.

25. Both the IASB and FASB staff think that, if the boards agree with the staff recommendations in this paper there is no need for the boards to revisit their previous decision that in the premium allocation approach:

(a) the liability for remaining coverage at inception of the contract should be the premium, if any, received at initial recognition, plus the expected present value of future premiums, if any, that are within the boundary of the existing contract less directly attributable acquisition costs (for the FASB limited to successful acquisition efforts only); consistent with the decision made for the building block approach.

(b) insurers should be permitted to recognise all acquisition costs as an expense if the contract coverage period is one year or less.

Acquisition costs in the premium allocation approach
Do the boards think that: *Alternative B* An insurer should: (a) recognise the liability for remaining coverage net of acquisition costs (consistent with the tentative decision from February 2012 joint board meeting). (b) recognize acquisition costs as an expense and premium, gross of the amortisation of acquisition costs, according to the pattern confirmed by the boards in April 2011.[18] The amortization of acquisition costs (according to the same pattern) should be shown separately. *Or Alternative C* An insurer should: (a) recognise the liability for remaining coverage net of acquisition costs (consistent with the tentative decision from February 2012 joint board meeting) (b) expense acquisition costs when incurred and at the same time recognize premium income equal to, and offsetting those acquisition costs. (c) recognise the remaining premium according to the pattern confirmed by the boards in April 2011.

[18] ie, 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. This pattern of recognition was proposed in the ED and confirmed in April 2011.