IASB Agenda ref	**2C**
FASB Agenda ref	**90C**

15-18 October 2012

STAFF PAPER

REG IASB/FASB Meeting

Project	**Insurance contracts**		
Paper topic	Presentation in statement of comprehensive income-acquisition costs		
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Purpose of this paper

1. This paper discusses the pattern of recognising acquisition costs and presenting these costs in the statement of comprehensive income.
2. The proposals in this paper do not affect the measurement of insurance contract liabilities.

Staff recommendation

3. The IASB staff recommend that the cash flows relating to acquisition costs should be recognised in the statement of comprehensive income over the coverage period.
4. The FASB staff recommend that acquisition costs should be:
    - (a) treated as part of the insurance liability, and
    - (b) recognised as part of the margin and either separately presented on the statement of financial position or included in the rollforward as part of the disclosures.

5. Both IASB staff and FASB staff recommend that acquisition costs should be recognised in the statement of comprehensive income in a way that is consistent with the proposed allocation of the residual/single margin[1], in other words:

   (a) For the IASB, in a way that is consistent with the pattern of transfer of services provided under the contract.

   (b) For the FASB, as the insurer satisfies its performance obligation to stand ready to compensate the policyholder if a specified uncertain future event adversely affects that policyholder, which is when the insurer is released from exposure to risk as evidenced by a reduction in the variability of cash outflows.

Background and structure of this paper

6. The IASB Exposure Draft *Insurance contracts* proposed a building block approach in which:

   (a) the measurement of insurance contract liabilities would include the expected present value of acquisition costs. (This was also proposed in the FASB Discussion Paper *Preliminary Views on Insurance contracts*.)

   (b) an insurer would present in the statement of comprehensive income only net changes in the liability (summarised margin presentation[2]). This meant that no volume information such as premiums, claims, acquisition costs or other expenses would be included in the statement

[1] For the IASB staff, this assumes that the boards agree with the staff recommendation in agenda paper 2A/90A that premiums should be recognised in the statement of comprehensive income on an earned basis.

[2] Paragraph 125 of the FASB's DP set out the FASB's preliminary views as follows:

"The majority of Board members agree with the IASB's proposal to use a margin presentation of insurance contracts measured under the building-block approach. Additionally, the Board has indicated a preference for the use of a premium presentation for contracts measured under the modified approach. However, the Board has not determined which contracts would be measured according to the modified approach and is concerned about the use of two different presentation approaches for insurance contracts. As such, the Board is soliciting additional feedback from stakeholders on the usefulness of the information provided by either a margin presentation approach or a premium presentation approach for insurance contracts and which contracts would use each approach."

of comprehensive income. Instead, the Exposure Draft proposed the disclosure of such information.

7. The IASB's ED[3] also proposed a premium allocation approach, for which there was an inconsistency between measurement and presentation for acquisition costs:

   (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 (and were presented separately), even though no separate asset was recognised.

8. The respondents to the ED/DP argued that information about premiums, claims and expenses is important for the building block approach, as well as for the premium allocation approach, and that this information should be presented in the statement of comprehensive income, and not just in the notes. As a response to those comments, the boards decided that insurers should present information about premiums, claims and benefits in the statement of comprehensive income. The method for presenting premiums, claims and expense information in the statement of comprehensive income is discussed in agenda paper 2A/90A.

9. In the boards' deliberations, an outstanding issue is the presentation of acquisition costs in the statement of comprehensive income. The IASB and FASB discussed some alternatives during the joint May 2012 board meeting. At that meeting

[3] Paragraph 106 of the FASB's DP noted:

"Although several Board members agree with some of the recognition and measurement provisions for the modified approach in the IASB's Exposure Draft, the Board has not determined [….] whether incremental acquisition costs would reduce the preclaims liabilities" (ie whether the acquisition costs would reduce the liability for remaining coverage under the premium allocation approach.)

neither the IASB nor the FASB reached final conclusions on the presentation of acquisition costs. However, the IASB and FASB reached differing preliminary conclusions, namely:

(a) the IASB tentatively confirmed that an insurer should include acquisition costs in the cash flows used to determine the margin (and hence the insurance contract liability), rather than account for them as the costs of a separate deferred acquisition cost asset. At a subsequent education session (in June 2012), IASB members indicated a preference for an approach that requires an insurer to recognise the acquisition costs and related premiums in the statement of comprehensive income over the coverage period, rather than when the costs are incurred (which is often at the beginning of the contract). The IASB asked the staff to consider how to allocate the acquisition costs and related premium when the staff considers the method for presenting premiums, claims and expense information.

(b) the FASB tentatively decided against an approach that would require an insurer to expense the acquisition costs and recognise income equal to, and offsetting, those costs when the acquisition costs are incurred. The FASB noted that it will consider at a future meeting:

  (i) An approach which recognises the right to recover acquisition costs as an asset.

  (ii) An approach which requires 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 single margin and allocated to profit or loss in the same way as the single margin.

  An analysis of these approaches was provided in agenda paper 2C/83C *Acquistion costs in the building block approach* from the May 2012 meeting. We reproduce extracts from this paper discussing approaches (i) and (ii) in Appendices D and E.

10. Accordingly, this paper first discusses:

    (a) (For the IASB) whether acquisition costs and related premiums should be recognised in the statement of comprehensive income over time[4], rather than when the costs are incurred (which is often at the beginning of the contract) (see paragraphs 16-18)

    (b) (For the FASB) whether acquisition costs and related premiums should be treated as part of the insurance liability (specifically, as part of the margin) and recognised in the statement of comprehensive income over time[5], rather than being recognised as an asset (see paragraphs 19-20)

11. Assuming both boards prefer an approach that treats acquisition costs as part of the insurance liability (either as part of the expected cash flows or as part of the margin), this paper considers a way in which acquisition costs could be recognised over time in the context of the three alternatives for premium presentation approaches discussed in agenda paper 2A/90A premiums written, premiums due, and premiums earned (paragraphs 26-33).

12. We note that this approach could equally be applied to the recognition of acquisition costs in the premium allocation approach.

    (a) For the premium allocation approach, the residual/single margin is implicit in the liability for remaining coverage. Thus in the premium allocation approach, acquisition costs would be released in line with the pattern of the release of the liability for remaining coverage, or the unearned premium. This is consistent with the notion that the premium allocation approach recognises the unearned premium (ie liability for remaining coverage) as the proportional release of each of the building blocks in the statement of comprehensive income.

[4] For the IASB, this would be over the coverage period as both the residual margin and the premium in the premium allocation approach would be allocated to profit and loss over the coverage period.

[5] In the FASB single margin, it is anticipated that most types of contracts under the building block approach will have release over the coverage period, as the risk of the settlement amount being different from the amount determined when the claim was incurred, which is the end of the coverage period, is nil. For the premium allocation approach, the release would be over the coverage period.

(b) The IASB has previously concluded that the premium allocation approach should be a proxy to the building block approach. Furthermore the IASB staff intend to ask the IASB to align the allocation pattern for the premium in the premium allocation approach and the residual margin in the building block approach. Accordingly, for the IASB, the same approach to recognising acquisition costs would be used for contracts accounted for using the building block approach and those accounted for using the premium allocation approach.

13. The appendices to this paper includes:

(a) Appendix A: The user outreach on acquisition costs

(b) Appendix B: a simple example illustrating the recognition of acquisition costs in an earned premium approach.

(c) Appendix C: Extract from IASB June 2012 agenda paper 2D *Timing of recognition of acquisition costs*

(d) Appendix D: Extract from agenda paper 2C/83C *Acquisition costs in the building block approach* from the May 2012 meeting – arguments in favour of Alternative A [an approach which recognises the right to recover acquisition costs as an asset]

(e) Appendix E: Extract from agenda paper 2C/83C *Acquisition costs in the building block approach* from the May 2012 meeting – arguments in favour of Alternative B [acquisition costs netted against the margin] and arguments in favour of Alternative C [acquisition costs included in cash flows]

Additional note on the need for impairment testing

14. If acquisition costs are included in the liability measurement, no separate impairment testing would be necessary. Any deficiencies in premium (including those caused by the acquisition costs) would be captured by the insurance contracts measurement model, specifically by the requirement that the residual or single margin cannot be negative in the building block approach at inception and

subsequently. Consequently, all negative changes in estimations would be recognised:

(a) For the IASB all changes would be accounted for against the margin. When the margin is exhausted the excess would be recognised in the statement of comprehensive income.

(b) For the FASB, the changes should be reported in the income statement immediately. If an insurer determines that a portfolio of contracts is onerous, an additional liability (measured as the present value of future payments for benefits and related settlement and maintenance costs less the present value of future premiums less the insurance contract liability) should be recognized with a corresponding offset to eliminate any remaining margin. If the additional liability is greater than the remaining margin, an expense should be recorded for the remaining amount.

15. For the premium allocation approach, for the liability for remaining coverage, any deficiencies in premium would be captured by the additional liability that would be recognised as a result of an onerous contract test.

Staff analysis

Recognition of acquisition costs over time or as incurred (for IASB only)

16. In June 2012, the IASB considered agenda paper 2D *Timing of recognition of acquisition cost expense and related premium*[6]. That paper:

(a) Presented an analysis of when the premium charged to cover acquisition costs would be recognised in each of the presentation approaches being considered by the board (ie written premium,

[6] That paper was presented to the IASB and not to the FASB because, in May 2012, the FASB had already rejected recognising acquisition costs as incurred.

premiums due and earned premium) if the board treated acquisition costs in the same way as other cash flows, ie as incurred.

(b) discussed whether an insurer would recognise acquisition cost expense and the related premium when the insurer incurs those acquisition costs or whether it would recognise them over time.

17. The arguments for and against recognising acquisition costs over time, rather than as incurred were set out in agenda paper 2D for the June 2012 meeting. We have reproduced the relevant extracts of agenda paper 2D in Appendix C.

18. At its June 2012 meeting, the IASB indicated a preference to recognise acquisition costs over the coverage period of the contract. Accordingly, we assume for the rest of this paper that the IASB will confirm that preference.

Question for IASB: Timing of recognition of acquisition cost income and expense
Do you agree that the cash flows relating to acquisition costs should be recognised in the statement of comprehensive income over the coverage period?

Treatment of acquisition costs as part of the insurance liability and recognition over the life of the contract (for FASB only)

19. In May 2012, the FASB considered agenda paper 2C/83C *Acquisition costs in the building block approach*, which included an alternative to recognise acquisition costs as an asset. The arguments for and against recognising acquisition costs as an asset and amortising them over time were set out in this paper. We have reproduced the relevant extracts of agenda paper 2C/83C in Appendix D.

20. At its May 2012 meeting, some FASB board members indicated a preference to recognise acquisition costs as part of the insurance liability (specifically, as part of the margin), to the extent this approach would achieve convergence with the IASB.

21. The FASB staff recommendation in agenda paper 2C/83C was that an insurer should recognise a reduction in the margin when the acquisition costs are incurred, with no net 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. However, in this paper and as discussed in the May 2012 meeting, the staff would modify that proposal to gross up the margin to present the acquisition costs. This alternative could be applied as follows: insurers could track the components of the margin separately, or determine acquisition costs as a percentage of the margin at inception of the portfolio of contracts, and apply that percentage in subsequent years for disclosure purposes. Once this amount were determined, the premiums related to the release of the margin would be grossed up every period for presentation in the statement of comprehensive income such that the insurer recognises the full amount of the premium received from the policyholder over time.[7]

22. The arguments for and against this approach were described in more details in agenda paper 2C/83C for the joint May 2012 meeting, and reproduced in appendix E. These arguments are summarized as follows:

    (a) Some regard the cash flows relating to claims and benefits as economically different from the cash flows relating to acquisition costs and the margin. Those with this view see a distinction between costs to fulfil the contract and those to obtain a contract.

    (b) Some regard the margin as distinct from the other parts of the insurance liability, and the acquisition costs as part of the margin (ie changes in acquisition costs impact an insurer's profit). As a result, some find it intuitive to think of the acquisition costs as reducing the margin, and

[7] It should be noted that when the new contracts are added, the percentage would need to be recalculated. However, the percentage of acquisition costs (and successful efforts) does not change frequently. Any changes would typically be known by management when the contracts are written. In addition, the staff understand that insurers are currently tracking these amounts (the acquisition costs as they relate to the margin on the contract), so this would not be costly or complex to introduce as part of the new model.

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. Similarly, users of financial statements do not typically include acquisition costs in analyses of an insurer's core business (eg underwriting). It would be consistent with the boards' previous tentative decisions that the margins should be recognized in the statement of comprehensive income separately, and that the part of the premium associated with the margin has a different earnings pattern than the part of the premium associated with the claims and benefits payments.

(c) If all changes in the insurance liability are shown together in one amount, users cannot determine if an insurer changed assumptions about the insurance obligation itself or simply paid acquisition costs (except from note disclosures). Likewise, in the statement of comprehensive income, it would offer greater transparency about the cash flows needed to pay policyholder claims and benefits as such cash flows would be shown separately from the effect of the margin net of acquisition costs.

(d) This approach is similar to recognizing acquisition costs as an asset and a separate gross margin liability. However, using this approach an insurer would be amortising one net amount, as opposed to a gross liability and gross asset.

23. As noted, Appendix D discusses the arguments for and against recognising acquisition costs as an asset. Accordingly, based on those arguments, the arguments in paragraph 22 for recognising acquisition costs as part of the margin, and the assumption that the FASB would like to consider this approach to align the FASB and IASB regarding the treatment of acquisition costs as part of the insurance liability, the staff therefore recommend rejecting recognising acquisition costs as an asset. As noted in 22(c), these approaches both have the effect of spreading the acquisition costs over time.

24. If acquisition costs are recognised as part of the margin, they could be disaggregated and separately presented on the balance sheet. If the FASB were to decide that it did not want to present the margin net of acquisition costs on the balance sheet, the staff note that these costs would be included in the rollforward of the margin as part of the disclosures.[8]

25. The staff note that the alternatives analysed below for recognising acquisition costs could also be considered as amortisation patterns if the FASB were to decide that acquisition costs should be recognised as an asset.

Question for FASB: Acquisition costs as part of the insurance liability
Do you agree that acquisition costs should be recognised as part of the insurance liability, rather than being recognised as an asset? If yes, do you agree that acquisition costs should be recognised as part of the margin and either separately presented on the balance sheet or included in the rollforward as part of the disclosures?[9]

Methods of recognising acquisition costs over time

26. Prior to discussing the recognition pattern for the acquisition costs, it is important to note that the boards tentatively decided to identify the components to which the total consideration is allocated: the expected cash flows, the risk adjustment with the remainder as the residual margin (for the IASB), the difference between the premium and the expected cash outflows as the single margin (for the FASB), each of which the boards tentatively decided a recognition pattern which differs amongst these components. The boards also tentatively decided that an insurer should exclude from premium presented in the statement of comprehensive income amounts that the insurer is obligated to pay the policyholder regardless of

[8] The package of disclosures agreed by the IASB at their meeting on 26 September 2012 included a requirement that an insurer shall show in the reconciliations of contract balances the direct costs of acquiring a portfolio of insurance contracts (see IASB agenda paper 16F for the September 2012 meeting).

[9] In May 2012, the IASB tentatively confirmed that an insurer should include acquisition costs in the cash flows used to determine the margin (and hence the insurance contracts liability), rather than account for them as a separate deferred acquisition cost asset. Thus, the IASB has already rejected this approach.

whether an insured event occurs, and that each of these components of premium should be earned according to a different pattern.

27. This section considers the pattern for recognising acquisition cost expense in the statement of comprehensive income over time. The rationale for recognising acquisition costs over time is that the insurer does not provide service, and the policyholder receives no benefit, when acquisition costs are incurred or paid. Accordingly, acquisition costs would be recognised over time when recovered by the insurer, which would be when the service is provided or benefit received.

28. The staff propose that the pattern for recognising acquisition costs should be consistent with the pattern for recognising the single/residual margin. This is because the rationale for recognising acquisition costs over time is the same as the rationale for recognising a single/residual margin: namely that revenue (ie premium) should only be recognised when an insurer performs under the contract. Accordingly, the basis for allocating acquisition costs over time should be the same as the basis for allocating the single/residual margin:

    (a) For the IASB, this would be in a way that is consistent with the pattern of transfer of services provided under the contract, and over the coverage period.[10]

    (b) For the FASB, this would be as the insurer satisfies its performance obligation to stand ready to compensate the policyholder if a specified uncertain future event adversely affects that policyholder, which is when the insurer is released from exposure to risk as evidenced by a reduction in the variability of cash outflows.

29. In addition, we note that recognizing the acquisition costs in this way would:

    (a) Be consistent with the amortisation pattern of deferred acquisition costs in the revenue recognition ED. In the revenue recognition ED the

[10] For the IASB, the residual margin would be unlocked to offset changes in estimates. In some cases, the residual margin may be eliminated. However, the pattern of transfer of services would not be affected by the unlocking of the residual margin, and the allocation of the acquisition costs would be based on the pattern of services directly, rather than indirectly through the pattern of the unlocked residual margin.

deferred acquisition cost asset would be released on a systematic basis consistent with the pattern of transfer of services. The FASB's single margin is released when the insurer is released from exposure to risk as evidenced by a reduction in the variability of cash outflows. Although the description differs, the concept is similar.

(b) If the FASB were to decide that acquisition costs should be netted against the single margin and presented separately from the present value of expected cash flows, then recognising residual/single margin and acquisition costs using the same allocation pattern would be consistent with the view underlying that approach, ie that acquisition costs are part of the margin and not part of the expected cash outflows to pay claims, benefits, or the related expenses (i.e., building block 1). To the extent acquisition costs are viewed as part of the liability, specifically as part of the margin, this approach would permit users to see the effects of payment of acquisition costs and release of margin separately from changes in the expected cash flows, which relate to insurer's obligation to fulfil the contract (reflecting the results of an insurer's core business).

(c) Recognising the acquisition costs in proportion to the margin release would be consistent with US GAAP for insurance contracts:

(i) For universal life-type contracts, deferred annuities and variable and equity-based life and annuity products where only the account balance is recorded in the statement of financial position and premiums are not recognized in the statement of comprehensive income (when applying the former FAS 97 model), the amortisation of deferred acquisition costs is based on a contract's present value of the gross profit expected to be generated by the portfolio of insurance contracts[11], using a retrospective catch-up approach.

(ii) Similarly, for participating contracts applying the former FAS 120 model, the amortisation of deferred acquisition costs is based on a contract's estimated gross margin, using a retrospective catch-up approach.

(iii) For contracts applying the former FAS 60 model, deferred acquisition costs are amortized over time proportional to premiums recognised in the statement of comprehensive income. Premiums under this model are recognized when due and include a profit component, however, not the entire expected profit in the portfolio of insurance contracts (the remainder is implicit in the measurement of the liability).

30. If the boards decide on a written premium approach in agenda paper 2A/90A, the staff note that a consistent allocation pattern for the residual/single margin and acquisition costs could result in the situation that the premium charged to cover acquisition costs may be recognised over time even though the remainder of the premium may be recognised upfront. That situation could also occur if the boards decide on a premiums due approach in agenda paper 2A/90A, if the premiums are

[11] Estimated gross profit (EGP) includes estimates of the following elements, each of which are determined based on the best estimate of that individual element over the life of the portfolio of contracts without provision for adverse deviation:

1. Amounts expected to be assessed for mortality (sometimes referred to as the cost of insurance) less benefit claims in excess of related policyholder balances
2. Amounts expected to be assessed for contract administration less costs incurred for contract administration (including acquisition costs not included in capitalized acquisition costs)
3. Amounts expected to be earned from the investment of policyholder balances less interest credited to policyholder balances
4. Amounts expected to be assessed against policyholder balances upon termination of a contract (sometimes referred to as surrender charges)
5. Other expected assessments and credits, however characterized.

received upfront[12]. In those cases, the IASB staff believe that it may be more appropriate to recognise the acquisition costs as follows:

(a) If the board were to decide on a written premium approach, that the acquisition costs should be recognised upfront.

(b) If the board were to decide on a premiums due approach, that the acquisition costs should be recognised in proportion to the premiums due, consistent with the way that all other costs are spread.

31. This is because the IASB staff believe that there should be consistent treatment between the premium charged to cover acquisition costs and other premium. In the IASB's staff view, recognising acquisition costs in line with the service provided under the contract would be consistent with a premiums earned approach in which the premium is also recognised over time.

32. However, consistent with the IASB staff recommendation in agenda paper 2A/90A, the IASB staff recommend that acquisition costs should be recognised using the same pattern of allocation of margin.

33. The FASB staff find the arguments in paragraph 29 persuasive regardless of the pattern of earning premium[13] because:

(a) As discussed above, these staff view the part of the premium recognised for acquisition costs as economically distinct from the part of the premium recognised for fulfilling the insurance obligation (and therefore do not believe these should be recognised over the same pattern).

(b) In addition, as noted in paragraph 30, for contracts in which premium is paid upfront, using the pattern of premiums earned under a premiums

[12] Typically policyholders pay premiums over time rather than a single premium at the beginning of the coverage period.

[13] As highlighted in Agenda Paper 2A/90A, under the premiums written or due approach, the respective amount of premiums would be recognized with an offsetting entry for the amount of the risk adjustment (IASB only) and the single/residual margin which would be recognized in accordance with the board's tentative decisions. Therefore 100% of the consideration associated with these approaches would not contribute to the net results for the period.

written or premiums due approach would result in acquisition costs also recognised upfront before the insurer has performed its obligation (this approach was previously rejected by the FASB). Accordingly, the FASB staff recommend that acquisition costs should be recognised using the same pattern of allocation of margin regardless of the pattern of earning premium as this represents the recognition of the expected profit.

(c) If the acquisition costs were recognized based on a premiums written or due approach the staff would be concerned that insurers might recognize a net loss at the date the premium written or due is recognized (unless the margin is reduced by the amount of acquisition costs), which was one of the reasons not to expense acquisition costs as incurred.

(d) Another approach would need to be considered when the investment component is a significant component of the contract. In that case, the premiums that are recognized in the statement of comprehensive income alone may not cover the acquisition costs (i.e., only the premium for the insurance component with no premium for the investment component). In addition, there could be acquisition costs allocated to the investment component for which there may be no related premium recognized under the premium written or due approach. Regardless, the profit expected on the contract (both on the insurance and investment components) as measured in accordance with the liability, would cover the acquisition costs.

34. The staff also considered whether there could be other patterns of allocating acquisition costs over time, including based on the pattern of premiums earned, however, as noted in paragraph 28, the staff believes that the rationale for recognising acquisition costs over time is best satisfied by allocating acquisition costs in the way proposed.

Staff recommendation

Question for the IASB and FASB: Recognition of the acquisition costs in the building block approach

Do the Boards agree that acquisition costs should be recognised in the statement of comprehensive income in a way that is consistent with the proposed allocation of the residual/single margin[14], in other words:

- For the IASB, in a way that is consistent with the pattern of transfer of services provided under the contract

- For the FASB, as the insurer satisfies its performance obligation to stand ready to compensate the policyholder if a specified uncertain future event adversely affects that policyholder, which is when the insurer is released from exposure to risk as evidenced by a reduction in the variability of cash outflows.

[14] For the IASB staff, this assumes that the boards agree with the staff recommendation in agenda paper 2A/90A that premiums should be recognised in the statement of comprehensive income on an earned basis.

Appendix A: User outreach on acquisition costs

A1. Users of financial statements analyse the amount of acquisition costs incurred and the deferred acquisition cost asset that is recognised under many existing accounting practices for the following reasons:

(a) they compare acquisition costs relative to new contracts in-force as an efficiency measure, ie how well the insurer converts dollars spent on acquisition costs into new contracts over time. To get this measure, users would likely compare the expected premiums (received and/or to be received) to the expected acquisition costs (paid or to be paid) for the new contracts signed.

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

(c) they believe that more useful 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.

A2. Therefore, users of financial statements are more interested in the amount of expected acquisition costs and the related amount of business acquired, than in the amount of acquisition cost expense amortised each period.

Appendix B: Example illustrating how acquisition costs would be recognised in an earned premium presentation

A1. We illustrate how acquisition costs would be recognised in line with release of margin in an earned premium presentation, as described in the staff recommendation.

A2. Assumptions:

(a) 3 year contract;

(b) Premium equals CU 1,200 paid upfront;

(c) Expected outflows:

(i) Expected claims each year equal CU 300, paid as incurred;

(ii) Acquisition costs CU 90 paid upfront;

(d) Margin (of total CU 210) is released as follows: year 1: CU 50, year 2: CU 70, year 3: CU90;

(e) No changes in assumptions in expected cash flows for fulfilment of the insurance obligation or acquisition costs;

(f) For simplicity, it is assumed that the risk adjustment is zero and there is no interest accretion on the insurance liability.

Statement of financial position (components of the insurance liability)

	Year 0*	Year 0*	Year 1	Year 2	Year 3
Expected inflows	-1,200	-	-	-	-
Expected outflows for claims/benefits and related expenses	900	900	600	300	-
Expected outflows for acquisition costs	90				
Margin	210	210	160	90	-
Insurance liability	-	1,110	760	390	-

* At initial recognition the carrying amount of the insurance liability equals zero. Immediately after initial recognition the carrying amount of the insurance liability changes because of the payment of acquisition costs and receipt of premium.

Roll-forward of the insurance liability

	Year 0*	Year 0*	Year 1	Year 2	Year 3
Opening balance	-	-	1,110	760	390
Payment of premiums	-	1,200	-	-	-
Payment of claims	-		-300	-300	-300
Payment of acquisition costs		-90			
Residual/single margin release	-	-	-50	-70	-90
Closing balance	-	1,110	760	390	-

Calculation of premiums earned

	Year 0	Year 1	Year 2	Year 3	Total
Change in the insurance liability (excluding the margin)	- 900	300	300	300	-
Change in the margin	-210	50	70	90	
Premiums received	1,200	-	-	-	1,200
Acquisition costs*	-90	21	30	39	-
Premiums earned (including the margin)	-	371	400	429	1,200

* The acquisition costs are recognised in the statement of comprehensive income in relation to margin recognition pattern, for example for Year 1 CU 21 = CU 90 * CU 50/CU 210

Statement of comprehensive income when acquisition costs recognised in line with release of margin

	Year 0	Year 1	Year 2	Year 3	Total
Premiums earned (excluding margin)	-	300	300	300	900
Margin released[15]		71	100	129	300
Premiums earned (including the margin)	-	371	400	429	1,200
Claims incurred	-	-300	-300	-300	-900
Acquisition costs	-	-21	-30	-39	-90
Profit	-	50	70	90	210

Ratio	year 1	year 2	year 3	Total
Acquisition costs/Margin	30.0%	30.0%	30.0%	30%
Margin[16]/Total consideration	19.1%	25.0%	30.1%	25%
Acquisition costs/total consideration	5.6%	7.5%	9.1%	7.5%
Net margin[17]/total consideration	13.5%	17.5%	20.0%	17.5%

A3. It should be noted that the boards have not yet decided what disaggregated information would be directly available from the face of the financial statement for the contracts accounted for using the building block approach or would be in the disclosures.

[15] The staff have split out the margin grossed up by acquisition costs (ie in Y1 CU50+CU21=CU70) from premiums earned for illustrative purposes. The boards could decide that these items should be combined or disaggregated in the statement of comprehensive income.

[16] Ie including acquisition costs

[17] Ie excluding acquisition costs

Appendix C: Extracts from agenda paper 2D *Timing of recognition of acquisition cost expense and related premiums* from the June 2012 IASB meeting

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

Treating acquisition costs in the same way as other cash flows

11. In agenda papers 2B/84B and 2C/84C [for the June 2012 meeting], we consider three ways for determining how much premium would be recognised in each accounting period. If acquisition costs were treated in the same way as other cash flows, the following implications arise for each of those ways:
    (a) In a 'written premium'[18] approach, the insurer presents as premium the expected present value of all the premiums receivable within the boundary of contracts initially recognised in the period. That amount includes the premium charged to cover acquisition costs. As a result the premium charged to cover acquisition costs would be recognised in the period the contract is written.
    (b) In a 'premium due' approach, premiums are presented as revenue when expected to be receivable (and the corresponding increase in the liability is presented as an expense). As a result:
        (i) the premium charged to cover acquisition costs would be recognised when those premiums are expected to be receivable.

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

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

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

(c) In the earned premium approach discussed in agenda papers 2B/84B and 2C/84C, insurers would present a volume measure for insurance contracts that is similar to the measure of revenue that results from applying the requirements proposed in the draft Revenue standard.[19] That approach allocates revenue by reference to the initial estimates of the pattern of services provided in each period, eg by reference to the expected claims and other benefits in each period as estimated at the time of pricing the contract. This way of allocating revenue reflects a view that the service that the insurer transfers to the customer is insurance coverage and the amount recognised in each period is the amount that the insurer would have charged for each period of coverage if it had issued separate contracts for each period. (The amount charged would also include any

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

amount the insurer would charge for any option that the policyholder has to continue, extend or renew the contract.) Applying that view:

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

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

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

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

13. If this were the case, the staff proposes that this income and expense would be recognised over the coverage period in line with the pattern of services under the contract, consistently with the allocation of the residual margin.[20] Thus, an insurer would account for and present the cash flows relating to the recovery of acquisition costs in the same way as the other cash flows that are expected to arise in fulfilling the contract, but defer the recognition of premium equal to, and offsetting, the acquisition costs that are incurred over the coverage period. As with the premiums due approach, the acquisition costs could either be recognised when incurred, or deferred and recognised in the same pattern as the related premium. If the costs were deferred it would also result in similar accounting treatment to that achieved by the recognition

[20] The main body of this paper reconsiders this proposal.

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

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

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

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

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

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

the insurance contract and avoids the difficulties of identifying the total amount of acquisition costs in particular scenarios.

Appendix D – Extract from agenda paper 2C/83C, *Acquisition costs in the building block approach* from the May 2012 meeting

Arguments in favour of Alternative A [an approach which recognises the right to recover acquisition costs as an asset]

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:

(b) 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.

(c) 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.[21] From the purchaser's perspective, if the amount received in exchange for the block of business is less than the expected present value of the

[21] 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 (e.g. via reinsurance) before any coverage has been provided (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 ofCU94. 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.

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").[22]

(d) 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.

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:

    (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:

[22] 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.

(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 amortization 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.

Appendix E: Extract from agenda paper 2C/83C*Acquistion costs in the building block approach* from the May 2012 meeting

Arguments in favour of Alternative B [acquisition costs netted against the margin][23]

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.[24] 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.

[23] The staff propose to modify alternative B to gross up the margin to present the acquisition costs. For the FASB this alternative could be applied as follows: insurers could track the components of the margin separately, or determine acquisition costs as a percentage of the margin at inception of the portfolio of contracts, and apply that percentage in subsequent years for disclosure purposes. Once this amount were determined, the premiums related to the release of the margin would be grossed up every period for presentation in the statement of comprehensive income such that the insurer recognises the full amount of the premium received from the policyholder over the coverage period. However, many of these arguments remain valid.

[24] 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.

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-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[25]. 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

[25] 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.

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 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[26].

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 not reproduced] 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

[26] 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.

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 [acquisition costs included in cash flows]

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[27].

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:

[27] 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.

(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 the full amount of the customer consideration over the coverage and settlement periods.[28]

(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.

[28] 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, this could present operational complexity.