STAFF PAPER

20 September – 27 September 2012

REG FASB | IASB Meeting

Project	**Insurance Contracts**
Paper topic	Acquisition costs – accounting in the pre-coverage period

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

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB *Action Alert* or in IASB *Update*.

Purpose of this paper

1. This paper considers the accounting for acquisition costs in the pre-coverage period under the building block approach and premium allocation approach.

Staff recommendations

2. The staff recommend that acquisition costs incurred before a contract's coverage period begins should be recognized as part of the insurance liability for the portfolio of contracts where the contract will be recognized once the coverage period begins.

Staff analysis

3. In March 2011, the boards tentatively decided that insurers should not recognise an insurance contract until the coverage period starts, rather than at the inception of the contract (the date on which the insurer becomes party to the contract).[1] The reasons

[1] An insurer could become party to the contract, depending on the nature of the contract, when:

a) the insurer has offered coverage to potential policyholders, if that offer (including the price) is binding on the insurer,
b) only once the contract is in place—i.e. once the policyholder has accepted the contract—if the insurer can withdraw or re-price its offer before then, or
c) only once coverage starts, if the insurer can cancel or re-price the contract before then.

for this decision are discussed in agenda paper 3I/60I for the 14-18 March meeting. In summary, this decision was based on the following factors:

(a) an insurer should recognise an insurance contract asset or an insurance contract liability when the insurer is on risk, which typically will be the commencement of the coverage period

(b) prior to the coverage period, there is less certainty regarding the extent of an insurers' obligation, i.e. insurers might be unable to measure their liabilities reliably when they make binding offers because acceptance rates would be uncertain (specifically for group insurance products, reinsurance treaties, and shared risk contracts)

(c) the requirement to "recognise" the insurance contract means the contract needs to be tracked and accounted for, which would be operationally complex in the pre-coverage period

(d) the high cost to implement system changes (even if just to evaluate that the impact is immaterial) to make operational[2] does not outweigh the benefits

(e) in most cases the impact on the financial statements would be minimal and therefore the benefits to financial statement users, if any, would be low

4. In many contracts, the significant majority of acquisition costs incurred by insurers are commissions. Insurers do not typically pay commissions until the policyholder pays the contract's first year premium, which generally corresponds with the start of the coverage period. Some acquisition costs are incurred before the coverage period starts, e.g. employees' compensation and payroll-related fringe benefits related directly to underwriting, policy issuance, and medical inspection. The staff understands from insurers that these acquisition costs are immaterial relative to total acquisition costs incurred, but could still be significant.

5. In current practice, acquisition costs are recorded as expenses (ie debit expense, and credit cash) when incurred. Then, the expense is reversed, and the deferred acquisition cost asset is increased (ie debit deferred acquisition cost asset and credit

[2] All the FASB members and ten IASB members supported this decision (five voted against). The staff had divided views on the recommendations in that paper. Those opposing that decision noted that not recognising a contract from inception might introduce further operational difficulties. The staff did not, at that stage, discuss the issue discussed in this paper.

expense). Finally, the deferred acquisition cost asset is amortised over the coverage period according to the insurance product.

6. In the proposed insurance model, in cases where acquisition costs are incurred before the coverage period starts, an insurer may have incurred acquisition costs before the insurance liability has been recorded. Thus, the tentative decision to recognize an insurance contract when the coverage period starts, rather than at the inception (the date on which the insurer becomes party to the contract), results in the question of how to account for such acquisition costs, as some would argue that they cannot be included in the cash flows of the insurance contract liability if it has not been recognised.

7. To address this problem, the boards could require that acquisition costs incurred and/or paid before the coverage period begins should be accounted for in one of the following ways:

   (a) **Not recognised until the related coverage period begins (alternative 1).** This approach is consistent with recognizing all the cash flows incurred in acquiring and fulfilling the insurance contract in the same way. However, if the acquisition costs are paid in the precoverage period, then it is unclear what the corresponding double entry would be.

   (b) **Recognised as an expense when incurred (alternative 2).** This approach is inconsistent with the boards' tentative decisions to recognize acquisition costs over the coverage period[3].

   (c) **Recognise acquisition costs as a prepayment asset and derecognise that asset when the coverage period begins, when the acquisition costs are included as part of the insurance liability (alternative 3).** Under this approach, the insurer would also recognise the payable for acquisition costs incurred in the pre-coverage period. This approach is consistent with the view that any acquisition costs paid before the coverage period begins are a

[3] The boards could allow insurers to recognize an equivalent amount of premium as revenue when the acquisition costs are incurred, however, the FASB rejected this approach at the May 2012 joint board meeting. And the IASB, during the IASB education session in June 2012, indicated a preference for an approach which 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).

prepayment of the cash flows used to measure the insurance contract.

(d) **Recognised as part of the insurance liability when they are incurred (alternative 4).** This approach is the most practical approach operationally, as it considers how insurers track acquisition costs most efficiently – on a portfolio basis. It is inconsistent with the boards' tentative decision to not recognize an insurance contract until the coverage period begins because there is no recognised insurance contract liability (or margin) for the individual contract to which the acquisition costs relate if those costs are incurred in the pre-coverage period.

8. Regardless of the reasons noted in paragraph 3, some would argue that one way to avoid addressing this issue is to reconsider the decision to recognise contracts when the coverage period begins. Others would argue that reconsideration of that decision would not address this issue, as the acquisition costs that are incurred before the coverage period starts (e.g. employees' compensation and payroll-related fringe benefits related directly to underwriting and medical inspection and policy issuance) would still be incurred before the insurer becomes party to the contract. As noted above, the insurer would become party to the contract based on, among other indicators, when the insurer has offered coverage to potential policyholders, if that offer (including the price) is binding on the insurer. Once an insurer has offered a price to a policyholder, costs related to underwriting, and for example, medical and inspection, would have already been incurred (inputs used to price the contract). Therefore, these costs would still be incurred in the 'pre-coverage period', even if the boards were to reconsider the decision to recognise contracts when the period begins (ie to recognise them instead when the insurer becomes party to the contract).

9. Assuming that the boards do not want to revisit that previous decision or believe that previous decision will not address this issue, one of the four options listed in paragraph 4 needs to be chosen. The staff evaluated the options in the following paragraphs.

Alternative 1 (Not recognised until the related coverage period begins)

10. This approach would delay the recognition of expenses until the start of the coverage

period, but would require an insurer to track the amount of acquisition costs incurred. This is problematic because, as noted, the acquisition costs incurred in the pre-coverage period are often salaries for underwriters, which would be expensed when incurred, also in the pre-coverage period, and there would be no corresponding entry until the start of the coverage period. This results in potentially expensing the costs in one period, reversing the expense in a subsequent period, and then recognizing the expenses again over the coverage period. Therefore, the staff does not recommend the approach in alternative 1.

Alternative 2 (Recognised as an expense when incurred)

11. If those acquisition costs incurred before the coverage period begins are expensed when incurred, there would be inconsistent accounting treatment between the treatment of acquisition costs incurred before and after the start of the coverage period, assuming the acquisition costs incurred after the start of the coverage period are spread over the coverage period.[4] In addition, insurers expect contracts to be profitable, and acquisition costs to be recovered over time through premiums and other mechanisms. This approach could result in a day 1 loss, which would not reflect the insurer's business model. As noted, the boards have expressed a tentative preference that insurers should recognise acquisition costs over the coverage period, as opposed expensing acquisition costs as incurred.

12. Because the majority of underwriting, medical and inspection, and policy issuance efforts are performed before the coverage period begins (and before the insurer becomes party to the contract), alternative 2 would essentially change the boards' tentative decision on which costs should be included as acquisition costs in the measurement of the liability. It would be excluding from the costs categorized as acquisition costs those that are directly attributable to obtaining a portfolio of

[4] The boards have tentatively decided that insurers should be permitted to recognise all acquisition costs as an expense if the contract coverage period is one year or less in the premium allocation approach, so some acquisition costs are expensed in the proposed model. This is consistent with the practical expedient in revenue recognition. In addition, in practice, insurers that apply a short-duration model capitalize external incremental acquisition costs, and expense internal incremental acquisition costs as incurred. Tracking external incremental acquisition costs (commissions and premium taxes) is straightforward. However, the costs to perform regular cost studies and modify systems to track internal incremental acquisition costs (underwriting and policy issuance) may not outweigh the benefits.

contracts, and returning to the proposal in the IASB's ED and the FASB's DP that acquisition costs included in the measurement of the liability should be incremental (since the majority of acquisition costs incurred after the coverage period begins (or after the date on which the insurer becomes party to the contract) are commissions and premium taxes – incremental costs to obtaining the contract).

13. Therefore, the staff does not recommend alternative 2.

Alternative 3 (Recognised as a prepayment asset)

14. Insurers currently do not track acquisition costs at the individual contract level because of complexity, and because they believe the costs of doing so would not outweigh the benefits. This concern is reflected in the boards' tentative decision that the cash flows included in the initial measurement of insurance contracts should include acquisition costs that relate to a *portfolio* of insurance contracts (limited to successful contracts for the FASB). The boards have tentatively decided that a portion of employee's total compensation, including payroll-related fringe benefits, related directly to time spent on underwriting, policy issuance and processing, medical and inspection, and sales force contract selling should be included in the measurement of acquisition costs. Other than some commissions and potentially medical and inspection costs (if a third party vendor is used), the staff understands that insurers do not track these costs on an individual contract basis. Instead, they track a rolling account of acquisition costs over time on a portfolio basis (based on the expenses incurred and specified criteria that identify which costs should be included as acquisition costs).

15. In addition, in practice, the acquisition costs incurred in a period are not segregated based on those that related to the pre-coverage period versus the contract period (some insurers track renewal contract expenses, specifically for commissions, separately from new contract expenses).

16. The staff understands that a variant of alternative 3 is used in current practice in very limited circumstances. Those who apply this approach create a prepayment asset for acquisition costs that are paid before the coverage period begins, derecognise that asset when the coverage period begins, and then include those acquisition costs as

part of the deferred acquisition cost asset. This can be viewed as a better match of the costs incurred with the contracts that actually create those costs.

17. However, if alternative 3 were applied, the amount of the pre-paid asset would not be easily determinable for two reasons. First, the pre-paid asset would need to reflect the acquisition costs of an individual contract. In addition, for the pre-paid asset to be appropriately derecognized and included as part of the insurance liability, insurers would need to track the costs associated with each individual contract until the start of that contract's coverage period. In addition, systems would need modification to perform the reclassification at the beginning of the coverage period. Again, the majority of the costs incurred in the pre-coverage period relate to internal acquisition efforts, which are not tracked on an individual contract level.

18. Alternatively, to approximate alternative 3, the insurer could determine an average lag time by portfolio (the time between acquisition costs incurred in the pre-coverage period, and the recording of the individual contract insurance liability) and plan to recognize the acquisition costs after this lag time. However, this approach seems arbitrary, would still be costly, would not accurately match the costs incurred with the specific contracts that created those costs, and therefore may not provide useful information.

19. As described in paragraph 11, alternative 3 would also essentially change the boards' tentative decision on which costs to include as acquisition costs. It would exclude from the costs categorized as acquisition costs those that are directly attributable to obtaining a portfolio of contracts, and return to the proposal in the IASB's ED and the FASB's DP that acquisition costs included in the measurement of the liability should be incremental costs.

Alternative 4 (Recognised as part of the insurance liability when they are incurred)

20. To apply this approach, any acquisition costs incurred in the pre-coverage period would be included in the insurance liability for the portfolio of contracts to which the contract will belong once the coverage period begins. As noted, in current practice, insurers track acquisition costs on a portfolio basis as opposed to an individual contract basis, based on a rolling account of acquisition costs over time. They argue

that the costs do not outweigh the benefits of more granular accounting. The approach in alternative 4 would be consistent with the way in which insurers track these costs. The approach in alternative 4 is also consistent with the boards' tentative decision to include in the measurement of the liability costs directly attributable to acquiring the portfolio of insurance contracts, rather than costs at an individual contract level (alternative 3) or only incremental costs of obtaining the contract (alternatives 2 and 3) .

21. In addition, because the acquisition costs incurred in the pre-coverage period are not likely to be material to the total acquisition costs or to the insurance contract liability, the amount of these costs included in the insurance liability for the period of time from the inception of the contract to the start of the coverage period will have a minimal impact on financial statements.

Staff recommendation

22. Weighing the complexity, operational concerns, and costs of applying alternative 3 for little or no benefit provided to users of the financial statements, as well as the inconsistency of alternatives 1, 2, and 3, with the boards' tentative decisions, the staff recommend alternative 4 – that acquisition costs incurred in the pre-coverage period be recognized as part of the insurance liability for the portfolio of contracts to which the contract will belong once the coverage period begins.

Question: Acquisition costs incurred in the pre-coverage period
Do the boards agree that acquisition costs incurred before a contract's coverage period begins should be recognized as part of the insurance liability for the portfolio of contracts where the contract will be recognized once the coverage period begins?