IAA Committee on IASC Insurance Standards
DEFERRED ACQUISITION COSTS
Discussion Draft

Introduction

Generally, costs associated with the acquisition of a long term insurance contract exceed the fees that an insurer receives at the point of sale/issue of a contract. Any excess of acquisition costs over initial fees is typically recouped out of margins that are available through the remaining life of the contract.

If expenses and fees were accounted for on a cash basis, the above situation would lead to a reported loss at issue of a contract, with correspondingly higher profits (excess margins) being reported over the remaining life of the contract. Because such a practice provides a distorted picture of the performance of an insurer, a number of alternative techniques have been adopted to achieve a matching of acquisition costs and related fees over the life of a contract. This note describes two alternative techniques, and puts forward a view on how acquisition costs should be dealt with in a fair value accounting framework.

Techniques for Matching Acquisition Costs and Fees

Two alternative approaches are considered. Under both approaches, a key principle is that the basis for the valuation of policy liabilities needs to be consistent with the treatment of acquisition costs, if effective matching of costs and fees is to be achieved.

1. Deferral Of Acquisition Costs

Under this approach, defined acquisition costs are capitalized and recognized as an asset. This asset is systematically written down (amortized) over the life of the contract. In essence this approach is retrospective, as it alters the recognition of expenses to match the revenues.

In order to achieve consistency with this treatment of acquisition costs, it is necessary for the policy liability to be determined with no recognition of the margins available to recoup acquisition costs. Hence, for example, if acquisition costs are recouped out of a margin in the premium, then the policy liability would be determined as follows:

  Present value of future benefits
\+ Present value of future expenses
\- Present value of future gross premiums less acquisition cost recovery margins

Provided the adjustment in the policy liability for the acquisition cost recovery margin is consistent with the manner in which the acquisition costs are recognised, then this method achieves a matching of expenses and fees.

As an aside, there is presently no generally accepted definition of the types of acquisition costs that should be capitalized (deferred). For example, in the U.S., deferred acquisition costs are those acquisition costs that vary in a manner consistent with the amount of business written. In other countries, different definitions apply. Further, there is no generally accepted basis for determining acquisition cost recovery margins.

2. Acquisition Costs Not Deferred

Under this approach, acquisition costs are recognised as an expense as they are incurred.

For consistency, the policy liability is calculated with full recognition of the margins available to recoup acquisition costs. Hence, in the example cited above, the policy liability would be:

Present value of future benefits
\+ Present value of future expenses
\- Present value of future gross premiums

This approach is considered to be prospective, since it matches prospective revenues to expenses.

It is important to note that the reported profits under the two approaches outlined above will be identical if, under Alternative (1), the basis for the amortisation of the acquisition cost asset is consistent with the policy liability adjustment for the acquisition cost recovery margin. Achieving such consistency entails:

- initially setting the acquisition cost recovery margin such that the present value of this margin is equal to the amount of the acquisition costs; and

- thereafter, setting the deferred acquisition cost asset equal to the present value of the acquisition cost recovery margins.

Provided these conditions are met, the difference between the two approaches becomes one of presentation in the balance sheet. Under the first approach, an explicit unamortized acquisition cost asset is shown in the balance sheet, with a correspondingly higher policy liability; under the second approach, there is no unamortized acquisition cost asset, and the policy liability is correspondingly lower.

It is worth considering the circumstances where the two approaches would not be equivalent. If the unamortized acquisition cost asset is systematically written down on a basis which is independent of the pattern of acquisition cost recovery margins and is not subject to revaluation (e.g., in line with movements in market yields), then the reported profits and balance sheets under the two approaches would not necessarily be identical.

Treatment Of Acquisition Costs In A Fair Value Accounting Framework

It is considered that a prospective basis of measurement (as defined in alternative (2) above), as opposed to a retrospective basis, is consistent with a fair value accounting framework. Leaving aside matters of presentation, the key issue becomes the basis for the valuation of the acquisition cost recoveries. The appropriate measure thereof is the present value of the future acquisition cost recovery margins, as per the approach in (2) above, incorporated in the future gross premiums. In particular, this method provides:

- a value of the acquisition cost recoveries which will vary in line with changes in expected values; and
- a reliable measure of probable future economic benefits flowing from the acquisition of a life insurance contract.

By contrast, a retrospective, or historical measure of an unamortized acquisition cost asset would not vary in line with changes in expected values and does not provide a reliable measure of future economic benefits.

Presentational Issues

Where a policy liability is calculated using prospective techniques, the valuation of the acquisition cost recovery margins naturally forms part of the policy liability calculation (with the value of these components effectively being netted off the policy liability). Therefore, the most practical presentation would be to show a reduced policy liability, rather than an explicit unrecovered acquisition cost contra-liability. However, the present value of the acquisition cost recovery margins can be disclosed if there is a need to present this amount explicitly.

Conclusions

It is considered that:

1. a retrospective, or historical measure of unamortised acquisition costs is not consistent with a fair value accounting framework or with the IASC's definition of an asset;

2. the unamortised acquisition costs for a life insurance contract should be valued as the present value of the acquisition cost recovery margins (i.e. the present value of the components of revenue which are available to recover acquisition costs); and

3. if presented explicitly, the value of the acquisition cost recoveries should take the form of a contra-liability.

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