Acquisition costs
Issues Paper

Introduction

1 Some stakeholders were concerned that acquisition costs on new business that is expected to renew cannot be allocated to future periods. They considered that this results in incorrect matching of income and expenses over time and contracts being onerous in accounting (but not in economic reality).

2 In January 2019 the IASB tentatively decided to amend IFRS 17 to require an entity to:

(a) allocate to any expected contract renewals their related part of the insurance acquisition cash flows directly attributable to newly issued contracts;

(b) recognise the insurance acquisition cash flows allocated to expected contract renewals as assets applying paragraph 27 of IFRS 17 until the renewed contracts are recognised;

(c) assess the recoverability of any asset recognised applying paragraph 27 of IFRS 17 each period before the related contracts are recognised. The recoverability assessment would be based on the expected fulfilment cash flows of the related group of contracts;

(d) recognise a loss in profit or loss for any unrecoverable carrying amounts of the asset recognised by applying paragraph 27 of IFRS 17;

(e) recognise in profit or loss the reversal of some or all of any such loss previously recognised when the impairment conditions no longer exist or have improved.

3 In June 2018, the IASB tentatively decided (as part of the IASB's annual improvements to IFRS Standards) to amend the terminology in paragraph 27 of IFRS 17 to include insurance acquisition cash flows relating to insurance contracts in the group yet to be issued. The amended wording in the June 2018 IASB staff paper 2A was as follows:

> IFRS 17.27 *An entity shall recognise an asset or liability for any insurance acquisition cash flows relating to a group of ~~issued~~ insurance contracts issued or expected to be issued that the entity pays or receives before the group is recognised, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows when the group of insurance contracts to which the cash flows are allocated is recognised (see paragraph 38(b)).*

EFRAG assessment

4 EFRAG assesses that the IASB proposals with regards to the treatment of acquisition costs are a step in the right direction, as the resulting financial information will better reflect the economic substance of these transactions.

[Depending on the final wording in the ED: EFRAG recommends the IASB to provide clear guidance on how the recoverability of acquisition cash flows should be assessed.]

Summary of the EFRAG IAWG discussion

5 In February 2019, EFRAG IAWG indicated that the proposals made by the IASB with regards to acquisition costs is a step in the right direction

6 Due to time constraints EFRAG IAWG did not discuss the issue at their May 2019 meeting. Therefore EFRAG IAWG members provided written responses. Please refer to the section '*Supplementary information from EFRAG IAWG*' below.

Supplementary information from EFRAG IAWG

7 The following section provides some written input received on the following questions from EFRAG IAWG subsequent to the meeting in May 2019.

Question - Does EFRAG IAWG members consider that the recoverability of acquisition cash flows would be assessed based on future renewals of existing contracts only and not including future new contracts?

	Number of preparers	Number of auditors	Independent	Total
Based on future renewals of existing contracts only	1	2	1	4
Based on both future renewals of existing contracts only and future new contracts	1			1
Under investigation	1			1

8 Reasons provided for considering only future renewals of existing contracts:

(a) Acquisition cash flows are capitalised based on contracts expected to renew. (1 preparer)

(b) The IASB's January 2019 tentative decision does not mention expected future contracts. (1 auditor)

(c) High acquisition commission tends to pay a provider for customers he has helped to attract but one should first look at the contractual wording of the commission in order to determine the scope of new contracts eligible. (1 independent)

9 A reason provided for considering both future renewals of existing contracts only and future new contracts is that the IASB tentative decision (in June 2018, as part of the IASB's annual improvements) to include contracts "in the group yet to be issued" in paragraph 27 indicates that acquisition cash flows relate to both expected future new contracts and expected renewals of existing contracts. (1 preparer)

10 The preparer who is investigating indicated that it would depend on what extent the principle is based on the expected customer life.

Question - Does EFRAG IAWG members agree with the above assessment[1]? Are there additional arguments to support the assessment that should be considered in the Draft Comment Letter? Please explain.

	Number of preparers	Number of auditors	Independent	Total
Agreement with the IASB tentative decisions	1	1	1	3
No response/No answer to the question	2	1		3

Summary of the EFRAG TEG discussion – May 2019

11 **All EFRAG TEG members present (11)** agreed with the proposals made by the IASB with regards to acquisition costs.

12 However, EFRAG TEG members questioned what the final wording in the ED will be with regards to the recoverability assessment of acquisition costs. EFRAG TEG members were unsure whether the assessment will be based on future renewals of existing contracts only or future new contracts as well.

13 The following were noted:

(a) It should be based on renewals only and not future new business.

(b) The assessment will rely on the current in-force customer base or capacity of distribution.

(c) The asset to be assessed will be a risky asset (similar to an intangible asset) but it has value, therefore testing for the asset is critical as there is a probability that the value can decline rapidly in case of competitive pressure and considering the prevailing trends in the industry to invest in facilitating the switches from an insurer to another.

(d) One EFRAG TEG member considered that the impairment model should be simpler as it would be too complicated for contracts accounted for under the PAA.

(e) Another solution proposed was to recognise the asset as an intangible asset which should be amortised in order to avoid deferral for a long period which is similar to goodwill or indefinite life assets. It was also noted that the current wording of the tentative decision seemed to suggest an implicit form of amortisation was foreseen.

14 Therefore, EFRAG TEG members considered that the final wording should be assessed in order to see whether clarity is provided on how to make the impairment assessment referred to in the IASB's tentative decision.

Background information

EFRAG extensive case study

15 Number of respondents addressing the issue: 2.

16 Of the comments received:

(a) One respondent illustrated the impact of the treatment of acquisition costs relying on a property and casualty portfolio. The respondent found limited losses on onerous contracts, while demonstrating an overall profit on the line

[1] The assessment was that the IASB proposals are a step in the right direction, as the resulting financial information will better reflect the economic substance of these transactions.

of business (the results were based on a combination of two portfolios). The respondent noted that the pricing reflects expected renewals.

(b) One respondent described the situation for property and casualty business where acquisition costs are unconditionally paid, i.e. without any claw-back clause if the contract is not renewed after the first year. The respondent notes there are strong historical records of persistence of the contracts (i.e. many of the policyholders continue the contract beyond the first year). Hence, the respondent argues that the economic duration of the contracts is longer than the contract boundary as defined in IFRS 17. This respondent quantified the difference between assigning the acquisition costs to new clients only, or to new clients and renewals. The respondent found that attributing acquisition costs to new clients only can lead to more onerous contracts. Further, this respondent noted that renewals can indirectly impact pricing as profitability assumptions are based on the expectation that contracts will be renewed over several years.

This respondent provided the following calculations for its portfolio (for reasons of confidentiality, the impact is reported in percentages).

Acquisition costs allocated to:	**A. New clients only**	**B. Renewals only**	**A+B New business (New clients and renewals together)**
Pre-tax profit	(75%) negative	175% (positive)	100% (overall positive)

17 Explanation: when acquisition costs are allocated to the new business in their entirety (new clients and renewals together), the portfolio is overall profitable. However, when the acquisition costs are allocated partly to new clients and partly renewals, the allocation to new clients becomes onerous. Also, what can be drawn from this example is that the major part of the acquisition costs is attributed to renewals of the contracts from a commercial perspective.

Question for EFRAG Board and EFRAG TEG

18 Members are invited to note the views of EFRAG IAWG and EFRAG TEG support the changes proposed by the IASB.

19 Based on the technical discussions presented above, what are your comments and orientation at this stage of the process?

Appendix: Input from ANC and CFO Forum

Input from ANC

20 In the ANC's view an interpretation does not appear sufficient to properly address the issue.

21 Amending IFRS 17.27 in order to separately recognise as an asset acquisition costs that (i) actually relate to the creation of a new customer relationship, (ii) are expected to generate benefits for the initial period and subsequent periods, (iii) provided that an impairment test is performed and (iv) disregarding the date of payment.

22 A suggested alternative solution is to assess whether contract renewals are likely to happen as expected and where they did not, the associated not yet allocated acquisition costs being then released to profit or loss immediately.

23 If a full impairment test is preferred (as already expressed by IASB in its tentative decisions in January 2019), in our view, an onerous test should be performed only if the change in the renewal pattern introduces a significant risk of group of contracts becoming onerous.

Suggested modifications (on the basis of the staff suggestion)

IFRS 17.27 (marked-up): An entity shall recognise an asset or liability for any insurance acquisition cash flows relating to ~~a group of issued~~ insurance contracts issued or expected to be issued ~~that the entity pays or receives before the group is recognised~~, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows ~~when~~ upon initial recognition of the group of insurance contracts and expected subsequent renewals to which the cash flows are allocated ~~is recognised~~ (see paragraph 38(b))

IFRS 17.27 (clean): An entity shall recognise an asset or liability for any insurance acquisition cash flows attributable to insurance contracts issued or expected to be issued, unless it chooses to recognise them as expenses or income applying paragraph 59(a). An entity shall derecognise the asset or liability resulting from such insurance acquisition cash flows upon initial recognition of the group of insurance contracts and expected subsequent renewals to which the cash flows are allocated (see paragraph 38(b))

Additional possible amendment 1

The following specific requirement might be added if IFRS 17.26 as it stands is not considered sufficient to address the valuation test of the asset recognised according to IFRS 17.27:

"An entity shall assess whether contract renewals happened as expected and where they did not, the associated unallocated acquisition costs being then released to profit or loss immediately".

Or additional possible amendment 2

The following specific requirement might be added if IFRS 17.26 as it stands is not considered sufficient to address the valuation test of the asset recognised according to IFRS 17.27:

"An entity shall recognise an impairment loss of the carrying amount of the assets related to expected renewals to the extent such amount is related to future groups expected to be onerous.

Input from the CFO Forum

24 The CFO Forum suggested the following: 'Amend the wording to permit acquisition costs to be amortised over the expected economic benefit period (initial contract and expected renewals), in combination with an impairment test.'

25 In the presentation to EFRAG TEG in March 2019 the issue was considered entirely solved without residual concerns.