

Technical Line

FASB – final guidance

Deferred acquisition costs – less is more

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What you need to know

- ▶ Insurance companies' deferrable acquisition costs are limited to costs directly related to the successful acquisition of insurance contracts.
- ▶ Companies need to capture and analyze information to identify costs that meet the definition of acquisition costs.

Overview

Under Accounting Standards Codification (ASC) 944-30,² insurance companies can capitalize only the following costs related to the acquisition of new and renewal insurance contracts:

- ▶ Incremental direct costs of a successful contract acquisition
- ▶ Portions of employees' salaries and benefits directly related to time spent performing specified acquisition activities for a contract that has been acquired
- ▶ Other costs directly related to the specified acquisition activities that would not have been incurred had that acquisition contract transaction not occurred

The guidance was issued¹ by the Financial Accounting Standards Board (FASB) to address concerns that insurance companies were capitalizing a wide range of costs when issuing or renewing insurance contracts and that the types of costs being capitalized varied from company to company. In addition, the Securities and Exchange Commission (SEC) staff had questioned in particular the deferral of advertising and overhead costs.

The guidance was effective for fiscal years, and interim periods within those fiscal years, beginning on or after 15 December 2011, through prospective or retrospective application. o

Key amendments

Successful efforts

Under the guidance, only acquisition costs resulting from the actual acquisition of a contract (i.e., successful efforts) can be capitalized as deferred acquisition costs (DAC). Previously, insurance companies may have capitalized certain costs relating to acquisition activities (e.g., underwriting-related costs), regardless of whether a contract was acquired.

How we see it

The successful efforts concept results in fewer costs being capitalized than under previous US GAAP. Companies need to track the time spent by employees on specified activities associated with successful contract issuance, which requires effective analyses.

Incremental direct costs

Incremental direct costs result directly from and are essential to the contract transaction and would not have been incurred by the insurance company had the transaction not occurred.

Examples of incremental direct costs subject to deferral include:

- ▶ Employee, agent or broker commissions for successful contract acquisitions
- ▶ Renewal commissions and bonuses to agents or brokers
- ▶ Third-party medical or inspection fees for successful contract acquisitions
- ▶ Premium-related taxes and assessments

This is not an all-inclusive list. A company should evaluate all costs it incurs when issuing a new or renewal contract to determine whether the costs qualify for capitalization.

Salaries, benefits and other costs directly related to acquisition activities

Under the guidance, a company defers a portion of employees' salaries and benefits relating to defined acquisition activities that lead to the successful issuance or renewal of an insurance contract (excluding incremental compensation).

Acquisition activities are defined as underwriting, contract issuance and processing activities, medical and inspection activities and sales force contract selling.

Benefits include payroll-related fringe benefits, such as:

- ▶ Payroll taxes
- ▶ Dental and medical insurance
- ▶ Group life insurance
- ▶ Retirement plans
- ▶ 401(k) plans and stock compensation plans
- ▶ Overtime meal allowances

A portion of total compensation of any employee who spends time approving successful insurance contracts may be capitalized as DAC. To capitalize a portion of salaries and benefits for executives and supervisors, two criteria are required to be met:

- ▶ The employee has a direct role in acquisition activities
- ▶ The activity is an essential activity resulting in the contract being issued

Illustration 1 – Deferrable compensation

Life Company A has established an underwriting approval authorization policy based on an underwriter's experience level and the size of the insurance contract.

Experience level	Authorization level
A – Less than 1 year	up to \$50,000 coverage
B – 1 year through 5 years	up to \$200,000 coverage
C – Greater than 5 years	up to \$500,000 coverage

Any contract greater than \$500,000 requires approval from an underwriting vice president (VP).

Any contract greater than \$1,000,000 requires approval from the Contracts Approval Committee.

Example 1: A \$750,000 contract has been received, and Underwriter A, C and the VP process and approve the contract for issuance.

A portion of whose salary and benefits should be included in the DAC?

Salaries and benefits relating to Underwriter A, C and the VP should be included in the determination of DAC, because each of those employees had a direct role in the underwriting process, and it was essential for all those levels to be included in the approval process.

Example 2: A \$200,000 contract application has been received, and Underwriter B is assigned to review and approve the contract. Underwriter B asks Underwriter C several questions about the applicant's medical history. Underwriter C assists Underwriter B with determining questions to ask the applicant and whether the contract application should be approved. The contract is ultimately approved. In addition, this contract was reviewed as part of the monthly underwriting quality review process after it is issued.

A portion of whose salary and benefits should be included in the DAC?

Only a portion of Underwriter B's salary and benefits would be included in the DAC. Although Underwriter C assisted in the review of the contract, Underwriter C's activities were not essential to the contract's issuance but were more supervisory in nature (their approval was not required).

Should a portion of the salary and benefits of the person performing the monthly quality review be included as DAC?

Costs related to the person performing the quality review should be expensed. Quality reviews may be part of the underwriting department's controls over appropriate contract issuance, but they are not essential to contract acquisition.

Other costs directly related to the specified acquisition activities that would not have been incurred had the contract not been issued also are deferrable (e.g., travel costs for employees making onsite risk inspections).

Advertising costs

ASC 944-30 indicates that direct-response advertising costs should be capitalized only if the following criteria are met:

- ▶ The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising.
- ▶ The direct-response advertising results in probable future benefits.

To capitalize direct-response advertising costs, the estimated future revenue attributable to a specific advertisement has to be sufficient to recover the future costs incurred to realize those revenues, including the deferrable advertising costs.

How we see it

ASC 944-30 intentionally established a high hurdle for the capitalization of direct-response advertising costs. The direct-response advertising has to be aimed primarily at eliciting sales from customers that can be shown to have responded to a specific advertisement.

In addition, a company has to demonstrate that the advertisement will result in probable future benefits. Companies are required to maintain supporting documentation that identifies the customer(s) and the specific advertisement that elicited the response to justify the cost deferrals.

Non-deferrable costs

Costs that are considered indirect such as administrative costs, rent, depreciation, occupancy and equipment costs and other general overhead costs are required to be expensed as incurred.

Costs related to a company's administration system or data processing equipment, even if dedicated to underwriting insurance contracts, do not qualify for capitalization but are categorized as equipment costs because they would have been incurred regardless of whether any contracts were issued.

All other acquisition-related costs, such as costs incurred by the insurer for soliciting potential customers and for market research, training, administration, unsuccessful contract acquisition efforts and product development, are charged to expense as incurred.

Endnotes:

¹ ASU 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*

² ASC 944-30, *Acquisition Costs*

The time that supervisors and executives spend on general supervision, oversight or training of employees are considered indirect costs and thus expensed as incurred.

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SCORE No. BB2102
(Updated 12 April 2023)

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Appendix: Questions and answers

This appendix provides questions and interpretive responses on issues companies may encounter when applying or considering the effect of the DAC guidance. The questions and answers are grouped into the following categories:

- ▶ Deferrable costs
- ▶ Successful efforts
- ▶ Advertising costs
- ▶ Accounting policy election¹

Deferrable costs

Question 1 Is a company required to track costs at the contract level to determine what is deferrable?

No. The guidance does not specify how deferrable costs are determined, but rather what costs should be deferred.

Companies need to have processes and systems in place that enable them to identify costs that meet the direct, incremental and essential requirements of the guidance for each class of business. In addition, companies need to have processes to determine potentially deferrable acquisition costs relating to contracts that were actually issued. This could be accomplished by tracking costs at the contract level, but we believe that other reasonable methods could be used.

Establishing a reasonable method of determining deferrable acquisition costs will be a matter of judgment based on the characteristics of the specific contracts and costs in question. Careful consideration should be given to factors such as the complexity of the underwriting process, the nature of other underwriting costs and other factors distinguishing the relative effort and costs for contracts accepted versus rejected.

For contract classes where the effort and relative costs are generally similar regardless of the outcome, a process based on standard costs or applications processed and issued may be appropriate. For classes of contracts where the underwriting effort and costs vary significantly from contract to contract, it may be more appropriate to track time and costs at the contract level.

No matter what method is used, a company should periodically analyze its continuing validity.

Question 2 How should a company account for costs incurred for pending contracts that have not yet been acquired?

As discussed in the previous question, a company may track costs by using one of several methods such as identifying costs at the contract level or using a reasonable estimate based on standard costs or applications processed and issued. Regardless of the method used, a company needs to assess whether contracts pending as of the balance sheet date are deemed unsuccessful before its financial statements are issued.

If the company is tracking deferrable costs at the contract level, one approach is to temporarily defer the costs incurred on all contracts in process in a suspense-like account until either the contract is acquired or considered to be an unsuccessful effort.

When using this approach, the company expenses any temporarily deferred costs relating to any contracts deemed unsuccessful after the balance sheet date but before the financial statements are issued. This approach is consistent with the guidance for origination costs incurred for loans in process.

Another approach is to estimate a successful efforts ratio and apply it to the costs incurred for contracts in process. This approach would work when a company defers costs relating to a group of contracts through an allocation method. A periodic reevaluation of the successful efforts ratio is necessary to assess whether it accurately estimates costs that eventually are deferred.

Question 3 Are overriding or overwrite commissions paid to independent third parties deferrable?

Overriding or overwrite commissions are paid on sales someone else makes. They generally are commissions paid to a broker, master general agent, general agent or another agent. For example, a company may have an agent with a 5% commission. This person may have a manager who receives 1% of the sales by all the people reporting to the manager as compensation. The 1% to the manager is an override.

When considering whether overriding commissions are deferrable, companies may analogize to the FASB's view² on overriding commissions contemplated for loan origination costs in ASC 310-20. The FASB decided that loan origination costs incurred by the lender in transactions with independent third parties should be deferred. The FASB noted that lenders would not be in a position to determine the portion of time spent on each activity and therefore would be unable to determine the specific amount of cost related to origination activities. Because of that difficulty, as well as the presumption that costs paid to an independent third party represent a reliable measure of the lender's economic sacrifice to acquire a specific loan, the FASB concluded that the costs should be deferred as incremental direct costs of loan origination.

In general, we expect overriding commissions paid to independent third parties to qualify for capitalization since the commissions are incremental direct costs related to a successful contract acquisition. However, a company should consider whether there are contracts or agreements that state that the purpose of the overriding commission is to cover costs that would not qualify for capitalization under the guidance (e.g., maintenance, overhead).

Question 4 Are bonuses payable upon achievement of selling a specified number of contracts or dollar amounts of contracts deferrable?

Yes. Volume-related sales bonuses related to achieving a certain threshold of contracts or dollar amounts of contracts meet the definition of incremental direct costs of contract acquisitions. The bonus would not have been incurred had the contracts not been acquired and are directly related to the sales of contracts.

Question 5 Are sales conference costs deferrable?

It depends. A company should use judgment in determining whether sales conference costs meet the definition of incremental direct costs of contract acquisitions. For example, if sales conferences are akin to volume-related bonuses, whereby sales agents who meet certain sales thresholds are rewarded with all-expense paid trips instead of cash commissions, a company may consider the cost to be deferrable.

Only the costs associated with the agents being rewarded are eligible for deferral. For example, costs for airfare, meals and entertainment might be eligible for deferral, while other costs, such as speaker fees, may be expensed as training costs. But if the sales conference is not a reward, is for all sales agents and includes non-deferrable activities, we do not believe it meets the requirements to be capitalized.

Question 6 **Are premium-related taxes and assessments deferrable?**

Yes. Premium taxes are payments to a state or municipality by an insurance company based on premiums paid by resident contract holders. Premium taxes and certain premium-related assessments qualify for capitalization because they result directly from the acquisition of a contract and would not have been incurred had the contract not been acquired.

The guidance on deferrable acquisition costs does not affect ASC 944-30-25-5, which addresses certain costs related to universal life-type products. Essentially, it provides that costs such as recurring premium taxes and ultimate level commissions, which vary with premium revenue, be charged to expense in the periods incurred.

Successful efforts**Question 7** **Should a company consider free look provisions to determine when a contract is considered successfully issued?**

A free look provision is a period of time immediately following the issuance of an insurance contract, generally between 10 and 30 days, during which a contract holder may legally cancel a contract with a full refund. The free look period differs depending on the terms of the insurance contract or the laws in a particular state.

Generally, for purposes of determining successful efforts, we believe that a contract that is cancelled by the contract holder during the free look period would not be considered successfully acquired. Therefore, a company should consider the duration of the free look period and the likelihood of contract holders cancelling their policies during the free look period to determine whether the free look provision could have a material effect on DAC.

Question 8 **What should be considered when a company is determining the portion of salaries and benefits related to time spent performing specified acquisition activities for successful contracts?**

Companies should consider two main steps:

- ▶ Determine the time spent on specific acquisition activities that would be considered deferrable time
- ▶ Determine and apply an appropriate successful efforts factor to the costs relating to the deferrable time

Companies may perform surveys, time studies or other analyses to determine how employees' time is spent. Idle time and time spent on activities for which costs cannot be deferred, regardless of successful or unsuccessful efforts, should be identified and excluded from deferrable time spent. These adjustments might include holiday, vacation and sick time, as well as training and general administrative time. Companies should assess the continued appropriateness of how employees' time is spent, including periodic updates to those surveys, time studies or other analyses.

Once the pool of costs relating to the deferrable time has been identified, the company could apply a ratio of number of successful contracts to total contracts (i.e., successful efforts factor). After establishing the successful efforts factor, a company will need to periodically assess it to determine whether it is still appropriate. We expect the factor to be assessed at least annually and more frequently depending on sales seasonality or changes in products/processes.

Since there may be meaningful differences in the processes, systems and reporting for different products or at different reporting locations, companies should determine multiple successful efforts factors. For example, if a company has multiple locations, each location may have different processes and spend a different amount of time on each contract.

Companies also may consider different successful efforts factors because the steps that occur earlier in the underwriting process may be assigned a lower successful efforts factor (e.g., the person who processes the initial application likely touches fewer successful contracts than an underwriter who reviews information after the medical inspection).

Advertising costs

Question 9 **How does a company demonstrate that the primary purpose of a specific advertising campaign is to elicit sales?**

Companies are required to maintain supporting documentation that identifies the contract holder(s) and the specific advertisement that elicited the response to justify the deferral of the costs. Companies need to determine that the advertising led directly to sales and was not a general solicitation of individuals that required further sales efforts to complete the contract issuance.

Examples of documentation that could link a customer response by name to a specific advertisement include a coded order form, coupon, response card or phone log.

Question 10 **How does a company demonstrate probable future benefits from direct-response advertising?**

Probable future benefits of direct-response advertising activities are probable future revenues generated from a specific advertising campaign. The estimated future revenue attributable to a specific advertisement has to be sufficient to recover the future costs to be incurred to realize those revenues, as well as the advertising costs deferred.

Question 11 **Can a company consider past advertising efforts to determine if current advertising for a new product is eligible for capitalization as direct-response advertising?**

Yes. However, to demonstrate such a benefit for new advertisements, a company needs to have a reasonable basis, including persuasive evidence, for concluding that the effects of the advertising costs incurred will be similar to those of past direct-response advertising that did result in a future benefit. The company needs to have verifiable information that supports the historical response rate.

Attributes to consider in determining whether responses to the new advertising will be similar to the responses to the old advertising include:

- ▶ Demographics of the audience
- ▶ Method of advertising
- ▶ Product being sold
- ▶ Economic conditions

The evidence a company develops to support the future benefits of its direct-response advertising costs has to be based on its own operating history. Response rates based on industry statistics are not acceptable. A company marketing a new product can look at the response rate on direct-response advertising for one of its other products, but only if it can demonstrate that response rates for the two products are likely to be highly correlated.

Accounting policy election¹

Question 12 Is a company required to capitalize all costs defined as deferrable under ASC 944-30?

No. ASC 944-30 contains an election that permits a company to continue using its current accounting policy if it results in fewer costs being capitalized than under the guidance, provided that all the costs currently capitalized by the company would qualify for capitalization under the revised model.

For example, a company that currently defers minimal acquisition costs (e.g., a property and casualty company that defers only commissions and premium taxes) may choose not to revise its capitalization policy to defer additional costs relating to other direct costs or a portion of employees' salaries or benefits for qualifying acquisition activities.

Question 13 Is a company permitted to develop an accounting policy under which it would capitalize only direct and incremental costs that can be easily identified with successful insurance contract acquisitions and renewals?

It depends. As noted in the previous question, a company may retain its current accounting policy if it results in fewer costs being capitalized than under the guidance, provided that the costs qualify for deferral. However, the guidance states only companies that expense costs that it defines as deferrable before implementing the guidance can expense those "types of costs" after implementing it. Therefore, if a company has an existing deferral policy that includes capitalizing certain salary-related underwriting costs, it would not be able to expense the component of underwriting salaries that would qualify for deferral since it previously deferred that type of cost. Judgment is required when determining what "types of costs" are deferred under companies' current accounting policies since the term is not defined in the guidance.

¹ The questions and answers in this category pertain to companies that have not previously adopted US GAAP and are now adopting this guidance.

² Paragraph BC8 of the Basis for Conclusions for ASU 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*