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Technical Line

FASB — final guidance

Deferred acquisition costs — less is more

In this issue:

What you need to know

- Under ASC 944-30, insurers' deferrable acquisition costs are limited to costs directly related to the successful acquisition of insurance contracts.
- Insurers need to have processes and systems to capture and analyze information to identify costs that meet the definition of acquisition costs and, therefore, should be capitalized.

Overview

Under Accounting Standards Codification (ASC) 944-30[1] insurers should capitalize only the following costs related to the successful 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 actually has been acquired
- Other costs directly related to the specified acquisition activities that would not have been incurred if the insurer had not entered into the acquired contract

The guidance was issued[2] by the Financial Accounting Standards Board (FASB) to address concerns that insurers 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.

Key provisions

Successful efforts

Under the guidance, only acquisition costs resulting from the actual acquisition of a contract (i.e., successful efforts) should 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**
>
> Insurers need to track the time their employees spent on specified activities associated with the successful issuance of a contract, which requires effective analyses.

Incremental direct costs

Incremental direct costs related to the acquisition of new or renewal insurance contracts should be capitalized. These are costs that result directly from and are essential to the contract and would not have been incurred by the insurer had that contract 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

An insurer should evaluate all costs it incurs when issuing a new or renewal contract to determine whether they should be capitalized.

Salaries, benefits and other costs directly related to acquisition activities

A portion of employees' salaries and benefits related to defined acquisition activities that lead to the successful issuance or renewal of an insurance contract (excluding any compensation already deferred as incremental direct costs of contract acquisition) should also be deferred.

Acquisition activities are defined as underwriting, policy 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 if the following criteria are met:

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

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

Illustration 1 — Deferrable compensation

Life Insurer has established an underwriting approval authorization policy based on an underwriter's experience level and the size of the insurance contract. In this process, Life Insurer starts with an underwriter with less experience and includes others if the authorization level is higher than the underwriter's level.

Underwriter	Authorization level
A	up to $50,000 coverage
B	up to $200,000 coverage
C	up to $500,000 coverage

Any contract greater than $500,000 but below $1 million requires approval from an underwriting vice president (VP).

Any contract greater than $1 million requires approval from the Contracts Approval Committee.

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

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

Salaries and benefits related to Underwriter A, Underwriter C and the VP should be included in the determination of DAC, because each individual had a direct role in the underwriting process, and it was essential for all 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 in determining questions to ask 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, that individual's activities were not essential to the contract's issuance but were more supervisory in nature (Underwriter C's approval was not required).

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

Costs related to the individual 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 that contract not been issued also are deferrable. An example would be travel costs for employees who make on-site risk inspections.

Advertising costs

ASC 944-30 states that direct-response advertising costs should be capitalized only if they meet the following criteria:

- The direct-response advertising must be aimed primarily at eliciting sales from customers that can be shown to have responded to a specific advertisement.
- The direct-response advertising must result in probable future benefits.

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 must exceed the future costs to be incurred, as well as the advertising costs deferred.

How we see it

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

In addition, an insurer has to demonstrate that the advertisement will result in probable future benefits. Insurers are required to maintain supporting documentation that identifies the contract holders and the advertisements that elicited the responses to justify the deferral of the costs.

Non-deferrable costs

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

Costs related to an insurer's administration system or data processing equipment, even if dedicated to underwriting insurance contracts, do not qualify for capitalization. Instead, they are categorized as equipment costs, since 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 costs for market research, training, administration, unsuccessful contract acquisition efforts and product development are expensed as incurred.

Endnotes:

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[1] ASC 944-30, *Acquisition Costs*.

[2] ASU 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts.*

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Appendix: Questions and answers

This appendix provides questions and interpretive responses on issues insurers 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 election

Deferrable costs

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

No. ASC 944 does not specify how deferrable costs are determined, but rather it specifies what costs should be deferred.

Insurers need processes and systems to identify direct, incremental and essential costs as defined in the guidance. The processes must determine potential DAC related to contracts that were actually issued. This could be accomplished by tracking costs at the contract level or using other reasonable methods.

Establishing a reasonable method for determining DAC requires insurers to apply judgment and evaluate the characteristics of the specific contracts and costs. Insurers should carefully consider 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 from those for contracts rejected.

For contract classes for which 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 for which 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.

Regardless of the method used, an insurer 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?**

An insurer may track costs by identifying them at the contract level or by using a reasonable estimate based on standard costs or applications processed and issued, among other methods. Regardless of the method used to track deferrable costs, an insurer should assess whether contracts pending as of the balance sheet date are deemed unsuccessful before its financial statements are issued.

An insurer that tracks deferrable costs at the contract level can temporarily defer the costs incurred on all contracts in process in a suspense-like account until the contract is either acquired or considered to be an unsuccessful effort. An insurer that uses this approach will have to expense any temporarily deferred costs related 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.

The insurer could also estimate a successful efforts ratio and apply it to the costs incurred for contracts in process. This approach works when an insurer defers costs related to a group of contracts using 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 made by a broker, master general agent, general agent or another agent. For example, an insurer may have an agent who charges 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, insurers may analogize to the FASB's view[1] on overriding commissions contemplated for loan origination costs in ASC 310-20. Under this view, 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 and 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, an insurer 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 (e.g., maintenance, overhead) under ASC 944-30-25-1A.

Question 4 **Are bonuses payable upon the sale of a specified number of contracts or dollar amounts of contracts deferrable?**

Yes. Volume-related sales bonuses, such as those tied 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 it is directly related to the sales of contracts.

Question 5 **Are sales conference costs deferrable?**

It depends. An insurer should use judgment to determine 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-expenses paid trips instead of cash commissions, an insurer may consider the cost to be deferrable.

Of course, 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. However, we believe a sales conference that is not a reward, is for all sales agents and includes non-deferrable activities would not meet the requirements to be capitalized.

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

Yes. Premium taxes are payments made by an insurer to a state or municipality that are 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.

However, ASC 944-30-25-5, which deals with certain costs related to universal life-type products, requires insurers to charge costs such as recurring premium taxes and ultimate level commissions, which vary with premiums, 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 after an insurance contract is issued, generally between 10 and 30 days, during which the contract holder may legally cancel a contract with a full refund. The length of the free look period depends on the terms of the insurance contract or the laws in a particular state.

Generally, for purposes of determining successful efforts, a contract that is cancelled by the contract holder during the free look period is not considered successfully acquired. Therefore, an insurer should determine whether free look refunds 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?**

Insurers should consider the following when determining the portion of salaries and benefits related to the time spent performing specified acquisition activities for successful contracts:

- Time spent on specific acquisition activities that would be considered deferrable time
- An appropriate successful efforts factor to the costs related to the deferrable time

Insurers may perform surveys, time studies or other analyses to determine how employee time is spent. Idle time and time spent on activities for which costs cannot be deferred should be identified and excluded from deferrable time. These non-deferrable costs or activities might include costs for holiday, vacation and sick time in a person's salary, as well as training and general administrative time. Insurers should assess the continued appropriateness of how employee time is spent, including making periodic updates to surveys, time studies or other analyses.

Once the pool of costs related to the deferrable time has been identified, the insurer could apply a ratio of number of successful contracts to total contracts (i.e., successful efforts factor). After establishing the successful efforts factor, the insurer 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 or processes.

There may be meaningful differences in the processes, systems and reporting for different products or at different reporting locations. Insurers may need to determine multiple successful efforts factors. For example, if an insurer has multiple locations, each location may have different processes and spend a different amount of time on each contract.

Insurers 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?**

Insurers are required to maintain supporting documentation that identifies the contract holders and the advertisements that elicited the responses to justify the deferral of the costs. They 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, phone log or email submission.

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 must exceed the future costs to be incurred, 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?**

An insurer can consider past advertising efforts to determine whether expenses for current advertising for a new product are eligible for capitalization as direct-response advertising expenses. To demonstrate such a linkage, the insurer must 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 insurer must have verifiable information that supports the historical response rate.

The attributes to consider in determining whether responses to new advertising will be similar to the responses to past advertising include:

- Audience demographics
- Advertising method
- Product being sold
- Economic conditions

The evidence that an insurer develops to support the future benefits of its direct-response advertising costs must be based on its own operating history. Response rates based on industry statistics are not acceptable. An insurer that is 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 election

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

Yes.

However, for insurers that followed US GAAP before the issuance of ASU 2010-26 and adopted the revised guidance that became effective for fiscal years and interim periods within those fiscal years beginning after 15 December 2011, ASC 944-30 contained a provision for a one-time election permitting an insurer to continue using its existing accounting policy if it resulted in fewer costs being capitalized than under the guidance, provided that all the costs capitalized by the insurer under its existing accounting policy would qualify for capitalization under the revised model.

Insurers that are established after 15 December 2011 or that convert to US GAAP as of or after 15 December 2011 are not eligible for this accounting policy election.

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[1] Paragraph BC8 of the Background Information and Basis for Conclusions of ASU 2010-26, *Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*.