

IFRS industry insights

IASB issues revised exposure draft on revenue recognition – insights for the insurance industry



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On 14 November 2011, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) jointly issued a re-exposure draft ED/2011/6 *Revenue from Contracts with Customers* ('the revised ED'). The revised ED is the next step in developing an entirely new revenue recognition standard and follows extensive outreach and redeliberations on the proposals in the original ED issued in June 2010. Although the underlying conceptual basis is unchanged, the IASB and the FASB (collectively 'the Boards') changed many detailed aspects of the original ED's proposals. As a result of these changes and the importance of the revenue line item to users of financial statements, the Boards decided to expose for public comment a revised ED. The comment period ended on 13 March 2012. The effective date of the proposed standard will not be earlier than for annual reporting periods beginning on or after 1 January 2015, with the IASB permitting early application.

This IFRS Industry Insight publication highlights aspects of the revised revenue ED as well as pertinent sections and tentative decisions from the insurance contracts project that may affect insurance entities.

Recently, the Boards have aligned certain aspects of the insurance contracts project with those in the revenue recognition project, potentially creating more parallels between the projects than was initially considered likely. This is particularly important because fixed-fee contracts that would otherwise meet the definition of an insurance contract would be likely to be scoped out of the insurance contracts project. Accordingly, entities would account for these contracts by applying the principles of revenue recognition guidance.

Because of the points of intersection between the insurance contracts and revenue recognition projects, entities will need to understand the accounting for both projects to gauge how significantly the new standards may affect their existing accounting policies.

Background

The revised ED's core principle is that "an entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

The revised ED would apply to all contracts with customers other than those within the scope of the leasing, insurance or financial instruments standards and non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers other than the parties to the exchange.

The revised proposals list five key steps for entities to follow in recognising revenue for contracts within the revised ED's scope:

1. Identify the contract with a customer;
2. Identify the separate performance obligations in the contract;
3. Determine the transaction price;
4. Allocate the transaction price to the separate performance obligations in the contract; and
5. Recognise revenue when (or as) the entity satisfies a performance obligation.

The objective of unbundling is to account for a component of an insurance contract in the same way for which a stand-alone contract with the characteristics of the unbundled component would be accounted.

In addition, the revised ED contains certain notable changes such as requiring the capitalisation of certain costs of obtaining and fulfilling a contract and amends the criteria for recognising losses on certain onerous performance obligations. Compared with current IFRS requirements, the revised ED would also require significantly expanded disclosures about revenue recognition including both quantitative and qualitative information about:

- the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers;
- the judgment, and changes in judgment, exercised in applying the proposal's provisions; and
- assets recognised from costs to obtain or fulfil a contract with a customer.

Insurance contracts scope exceptions

As part of the insurance contracts project, the Boards tentatively decided to define an insurance contract as "a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder." Under some contracts, a service provider charges its customers a fixed-fee in exchange for agreement to provide services to them if an uncertain future event occurs.

These contracts meet the definition of an insurance contract. However, the Boards agreed to exclude fixed-fee contracts from the scope of the insurance contracts standard. The scope exception would apply to any fixed-fee contract that provides service as its primary purpose and exhibits all of the following characteristics:

- the contract is not priced based on an assessment of the risk associated with an individual customer;
- the contract compensates customers by providing a service, rather than by paying cash; and
- the type of risk transferred relates mostly to the utilisation (or frequency) of services relative to the overall risk transferred.

Because such contracts would be outside the scope of the guidance on insurance contracts, entities would account for them under the revenue recognition guidance.

Contracts which may meet the criteria for the scope exception would include capitation and other fixed-fee medical service arrangements where the customer is not certain to receive a service from the provider unless certain medical events occur, typical fixed-fee prepaid maintenance and repair contracts and traditional roadside assistance programs. Although these types of fixed-fee contracts expose their vendors to risk related to uncertain events, they often do not transfer significant insurance risk (i.e., the additional benefits due on occurrence of such uncertain events are not significantly more than the benefits the contract would deliver in all other circumstances) and would not, therefore, meet the tentative definition of an insurance contract.

In addition to the new fixed-fee scope exclusion, the Boards have tentatively affirmed all scope exceptions initially proposed in the IASB's insurance contracts exposure draft and carried forward from the current text of IFRS 4 *Insurance Contracts*. Accordingly, entities would account for such contracts (e.g., product warranties) by applying the applicable IFRS – including revenue recognition in certain instances.

Potential points of intersection

The Boards have been mindful that the revenue and insurance projects contain certain common issues (e.g., whether the time value of money should be considered, and the treatment of contract acquisition costs and onerous contracts), and they have considered whether similar accounting requirements should apply to those items, or whether other considerations would justify different accounting treatments. Accordingly, various points of potential intersection have emerged.

Unbundling obligations to deliver goods and services from a host insurance contract

The objective of unbundling is to account for a component of an insurance contract in the same way for which a stand-alone contract with the characteristics of the unbundled component would be accounted. Once the Boards reach agreement on what should be unbundled (or separated and potentially disaggregated as in the case of investment components), agreement will also need to be reached on what guidance should apply to the unbundled component.

When an insurance contract is unbundled, the insurer would need to allocate the cash flows of the insurance contract between the components.

The Boards tentatively confirmed that goods and services could be unbundled from the insurance component based on a modification of the revenue recognition criteria for identifying separate performance obligations. Despite this agreement, subtle yet potentially significant differences arising from this decision exist and are discussed below.

Potential goods or services that might be unbundled

The insurance contracts project may not provide a list of goods or services that might require unbundling under the standard, primarily because the Boards believe that any list might deter entities from performing the necessary evaluation of specific circumstances to determine whether the unbundling criteria are satisfied. The Boards believe the conclusion around unbundling should depend on facts and circumstances.

For example, medical check-ups, a service commonly provided with health insurance contracts, is a service which may require unbundling. In some instances, as often is the case with health insurance, the obligation to provide such service to the policyholder would be unbundled on the basis of the criteria developed by the Boards. In other cases, medical check-ups may be viewed as an activity contingent upon the insurer's obligation to fulfil its insurance obligation and accordingly the component would not be unbundled.

Identifying separate performance obligations

One of the fundamental requirements of the revised ED is for entities to identify each of the separate performance obligations, requiring aggregation of goods and services that are not distinct. The revised ED refines the definition of 'distinct' and, except as explained below, a good or service is distinct if either of the following criteria is met:

- a) the entity regularly sells the good or service separately; or
- b) the customer can benefit from the good or service either on its own or together with resources that are readily available to the customer.

Notwithstanding those criteria, a good or service in a bundle of promised goods or services is not distinct, and therefore the bundle of goods or services would be treated as a single performance obligation, if both of the following criteria are met:

- a) the goods or services in the bundle are highly interrelated and transferring them to the customer requires the entity also to provide a significant service of integrating the goods or services into the combined item(s) for which the customer has contracted; and
- b) the bundle of goods or services is significantly modified or customised in order to fulfil the contract.

Under the insurance contracts project, only obligations to deliver goods or services that are distinct would be unbundled; all other obligations would be measured as part of the broader insurance contract.

When an insurance contract is unbundled, the insurer would need to allocate the cash flows of the insurance contract between the components. Significant difficulties in allocating cash flows are likely to arise when cash flows relate to more than one component, as is the case with many insurance arrangements, which may lead to significant costs and complexities for those insurers with an extensive number of contracts subject to unbundling.

Asset management fees

The revised ED may impact the timing of the recognition of revenue for asset management fees (i.e., contracts with variable consideration), a significant source of earnings for many life insurers, by constraining the cumulative amount of revenue recognised in a given period to an amount that should not exceed the amount to which the entity is reasonably assured to be entitled.

An entity would be reasonably assured to be entitled to the amount of consideration allocated to satisfied performance obligations only if both of the following criteria are met:

- the entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities); and
- the entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

The revised ED proposes that the incremental costs of obtaining a contract with a customer should be recognised as an asset if the entity expects to recover those costs.

This aspect of the revised ED may prove to be one of the most significant for insurance companies.

The fee structure of many insurance companies for managing separate accounts or other types of investment vehicles offered to their customers generally consists of a mix of base management fees and performance-based compensation. While the revised ED is not expected to affect significantly the recognition of base management fees, the effect on performance-based fees (which constitute variable consideration) may be more significant because such fees would only be recognised once reasonably assured.

Entities will need to consider whether their current policy for recognising performance-based revenue would remain appropriate under the basis of the revised proposals. Those currently recognising revenue based on projections of future performance could experience a significant change in their revenue recognition pattern as performance-based fees may not be considered reasonably assured until the end of the performance period under the revised ED. In situations in which the performance fee is subject to claw back provisions, the revised proposals may result in deferral of these contingent fee revenues for a significant period of time after the fees have been received by the insurance company (e.g., until completion of the respective transaction or performance period).

Under the revised ED's reasonably assured threshold, even if entities with performance-based fee arrangements have experience with similar contracts, that experience may not be predictive of the amount of consideration because it is dependent on factors outside the control of the entity, including fluctuations in the market risk and returns of the assets under management. As such, the entities might not be able to recognise the variable consideration based on projections of future performance.

However, recent responses to the revised ED indicate that some constituents believe that estimates of performance-based fees can be reasonably assured and therefore they would not be subject to the constraint on the amount of revenue that may be recognised, even if the final revenue amount is subject to volatility from the market prices of the associated assets under management. These respondents requested that the Boards clarify the factors (including volatility in market prices) used to determine when performance-based fees would or would not be reasonably assured.

Other fees and charges

Insurers may own a broker or mutual fund that distributes sponsored products for which it receives front-end loaded distribution or up-front fees.

The revised ED requires assessment of whether up-front fees qualify as a separate performance obligation. If the up-front fees were determined not to represent a separate performance obligation (i.e., not to result in the transfer of a promised service), revenue recognition would be deferred and the revenue would be recognised over the service period. This may be a change from current practice.

Contract acquisition costs

The revised ED proposes that the incremental costs of obtaining a contract with a customer should be recognised as an asset if the entity expects to recover those costs. Incremental costs are the costs that an entity incurs in its successful efforts to obtain a contract with a customer and that it would not have incurred if the contract had not been obtained (e.g., a sales commission). Costs that would have been incurred regardless of whether the contract was obtained should be recognised as an expense when incurred, unless they are explicitly chargeable to the customer regardless of whether the contract is obtained. As a practical expedient, acquisition costs incurred may be expensed instead of capitalised for those contracts where the period for the recognition of the associated revenue is expected to be of one year or less. Capitalised costs should be amortised "on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates." The period may extend beyond the initial contract term with the customer (e.g., considering contract renewals and related subsequent services).

Insurers frequently pay fees to third parties to distribute their products. In the recent round of comment letters, entities have asked the Boards whether third-party fees meet the proposed definition of incremental costs incurred in obtaining a contract (which would be deferred as an asset and amortised in a manner consistent with the pattern of transfer of services) or should be considered costs for fulfilling the performance obligation under the contract (which would be expensed as incurred) or would be excluded from the scope of the revised ED.

... the Boards have extended the insurance contracts project timeline ...

Next steps

The final revenue standard is currently expected to be issued in the first quarter of 2013. By comparison, the Boards have extended the insurance contracts project timeline with a new due process document (a re-exposure or a staff review draft of the new IFRS) expected to be published at some point in the second half of 2012. Based on this current timetable the final insurance standard's effective date is likely to be aligned with that of the revised financial instruments standard on 1 January 2015 or 2016.

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Designed and produced by The Creative Studio at Deloitte, London. 18565A

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