

In-depth

A look at current financial reporting issues

Revenue from contracts with customers

The standard is final – A comprehensive look at the new revenue model

Insurance intermediary industry supplement

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At a glance

In May 2014, the IASB and FASB issued their long-awaited converged standard on revenue recognition. Insurance intermediaries will be most affected by the new requirements on identifying separate performance obligations and variable consideration, such as contingent commissions and renewal commissions. Insurance intermediaries will need to consider changes that might be necessary to information technology systems, processes, and internal controls to capture new data and address changes in financial reporting.

[In depth 2014-02](#) is a comprehensive analysis of the revenue standard. This supplement discusses some of the more significant changes for insurance intermediaries.

Overview

Intermediaries introduce the policyholder and insurer, and are compensated by a fee or commission for placement/broking of an insurance policy. Services include introducing policyholders to the insurer, obtaining quotes from insurers and providing advice regarding which insurer would provide the required cover for a suitable price. Intermediaries can also earn revenue by performing a number of other services for insurers, such as underwriting, policy administration, claims processing services, loss prevention, risk management consulting, employee benefits consulting and captive management services. The amount of remuneration for these services is often contingent on the intermediary's performance. Captive management services might include business planning, regulatory compliance, financial accounting, management reporting and insurance underwriting.

Currently, under IFRS and US GAAP, insurance intermediaries recognise revenue from transactions based on the stage of completion, when the amount can be reasonably/reliably estimated and it is probable that the economic benefit will flow to the entity (IFRS), or when it is earned and realised or realisable (US GAAP). In some cases, the industry has interpreted this to be recognition of revenue upon receipt of cash. The revenue standard requires an insurance intermediary to recognise revenue as goods and services are transferred to the customer, using the amount that it expects to be entitled to in exchange for the services. The new guidance could lead to an acceleration of recognition of revenue – for example, in circumstances where an intermediary is entitled to contingent or renewal commissions and there are no further implied or contractual services to be performed in the renewal periods. In other instances (for example, in commercial lines of business where the intermediary performs ongoing services in addition to original placement), a portion of revenue, if material, would be recognised as those services are performed rather than at initial placement.

References to insurance intermediaries in this supplement refer to both insurance brokers and agents. In some territories, a distinction is made between insurance brokers and agents. An insurance agent is an insurance company's representative within the placement process. The agent, whose primary alliance is with the insurer, can be either a third party or an employee of the insurer. In this document, references to an agent refer to third party arrangements. In contrast, an insurance broker represents the policyholder and generally has no allegiance with any one insurance carrier.

This supplement provides an initial analysis of key questions and issues facing the industry which will continue to evolve as entities address the challenges of implementation and as the joint IASB/FASB Transition Resources Group (TRG) addresses various issues. The TRG was established in 2014 to help the IASB and FASB to determine whether more implementation guidance is needed. The TRG will make no formal recommendations to the boards or issue any guidance. The examples and related discussions are intended to highlight areas of focus to assist entities in evaluating the implications of the new standard. The new revenue standard is principles-based, requiring the application of significant judgement.

Five-step approach

Insurance intermediaries will need to assess their contracts to determine the timing and amount of revenue to recognise under the revenue standard. The model requires a contract-based approach under which the following steps will apply:

1. Identify the contract with the customer.
2. Identify the performance obligations in the contract.
3. Determine the total transaction price.
4. Allocate the total transaction price to each performance obligation in the contract.
5. Recognise as revenue when (or as) each performance obligation is satisfied.

[In depth 2014-02](#) contains a comprehensive analysis of these steps. The purpose of this industry supplement is to highlight the relevant areas for insurance intermediaries, which means that some steps might not be discussed in detail. Throughout the document we will refer to the five steps where appropriate.

Distinct performance obligations (step 2)

A performance obligation is a promise (whether explicit, implicit or implied by an entity's customary business practice) in a contract with a customer to transfer a distinct good or service to the customer. Identifying the separate performance obligations in a contract is essential to applying the revenue recognition model. Distinct performance obligations are the units of account to which the transaction price is allocated, and satisfaction of those separate performance obligations determines the timing of revenue recognition. Satisfaction of the performance obligation can occur at either a point in time or continuously over time, depending on the nature of the obligation.

A good or service is distinct only if:

- the customer can benefit from the good or service, either on its own or together with other readily available resources (that is, the goods or services are capable of being distinct); and
- the good or service is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

Determining whether a good or service is distinct within the context of the contract requires assessment of the contract terms and the intent of the parties. Indicators include, but are not limited to:

- The entity does not provide a significant service of integrating the individual goods or services in the contract into a bundle that is the combined item that the customer has contracted to receive.
- The good or service does not customise or significantly modify another contractually promised good or service.
- The good or service is not highly dependent on, or highly interrelated with, other goods or services in the contract.

In a joint meeting in February 2015, the FASB tentatively decided that an entity is not required to identify goods or services promised to the customer that are immaterial in the context of the contract and incorporated specific clarifying guidance on this issue in its exposure draft issued in May on identifying performance obligations. The IASB decided not to incorporate similar guidance into IFRS 15. An entity should assess whether performance obligations are immaterial to its financial statements, as described in IAS 8, 'Accounting Policies, Changes in Accounting Estimates and Errors'.

Variable consideration (step 3)

The transaction price might include an element of consideration that is variable or contingent on the outcome of future events, such as policy cancellations, lapses or renewals, volume of business or claims experience.

Variable consideration should be estimated using the method which best predicts the amount of consideration to which the entity will be entitled: the expected value or the most likely amount. The expected value approach represents the sum of probability-weighted amounts for various possible outcomes. The most likely amount represents the most likely amount in a range of possible amounts.

The approach used is not a policy choice. Management should use the approach that it expects will best predict the amount of consideration to which the entity will be entitled. This assessment would consider the terms of the contract and all reasonably available information, including historical, current and forecast information. The revenue standard notes that the information would be similar to the information that management uses in establishing prices for its services. The approach used should be applied consistently throughout the contract period.

In situations where an intermediary has a large number of contracts with similar characteristics, the expected value approach might be more appropriate. The entity would make use of experience of similar contracts, either in prior years or with other insurers in making its estimates. In addition, market data about similar contracts might provide evidence of possible outcomes.

Variable consideration included in the transaction price is subject to a constraint. An entity should recognise revenue as performance obligations are satisfied only if it is highly probable (IFRS) or probable (US GAAP) that a change in the estimate of the variable consideration would not result in a significant reversal of the cumulative revenue recognised. Factors to be considered in the assessment include whether the variability is significantly influenced by factors outside the entity's influence (such as market factors or the actions of third parties), the length of time the uncertainty is likely to exist, the entity's experience with similar transactions, and the number and range of outcomes.

Significant judgement might be required in the assessment of whether variable consideration will be subject to significant reversal. An entity should assess whether the range of potential outcomes is scattered or concentrated in a narrow range, and whether the outcome is skewed in a particular direction. If the distribution has a wide range of expected outcomes, it is more likely that revenue will be subject to significant reversal, and so a lower amount might need to be recognised.

Management will need to determine if there is a portion of the variable consideration (that is, some minimum amount) that will not result in a significant cumulative revenue reversal. If so, that portion of variable consideration will need to be included in the transaction price, even if the entire amount is not included. Management's estimate of the transaction price will be reassessed each reporting period, including the assessment of whether there is a minimum amount of variable consideration that the entity expects to receive.

The revenue standard specifies the accounting for an individual contract with a customer. However, if an entity uses an expected value approach to measure the transaction price for a portfolio of customers, it might also assess the impact of the constraint on variable consideration by reference to the same portfolio of contracts. We expect that the question of whether the assessment has to be done for an individual contract or for a portfolio will be discussed by the TRG at a future meeting.

Allocation of the transaction price to separate performance obligations (step 4)

Multiple performance obligations might exist in a contract with the customer. The transaction price is allocated to the separate performance obligations in a contract, based on the relative stand-alone selling prices of the services promised. This allocation is made at contract inception, and it is not adjusted to reflect subsequent changes in the stand-alone selling prices of those goods or services. The best evidence of stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately.

Recognition of revenue when (or as) each performance obligation is satisfied (step 5)

An entity recognises revenue when (or as) a service is transferred to the customer and the customer obtains control of that service. An entity should determine at contract inception whether control of a service is transferred over time or at a point in time. This determination should depict the transfer of benefits to the customer and should be evaluated from the customer's perspective. An entity should first assess whether the performance obligation is satisfied over time; if not, the service transfers at a point in time.

Placement of an insurance policy and other performance obligations

Besides the placement of an insurance policy, other performance obligations might exist in a contract which have to be identified in step 2, as discussed in the table. The commission received by an insurance intermediary for placement services might also include provisions for clawback upon cancellation or lapse by the policyholder, which qualify as variable consideration in step 3. The transaction price has to be allocated in step 4, and revenue recognised in step 5.

Relevant guidance for the recognition of revenue under the revenue standard, current IFRS and US GAAP is summarised below:

New revenue standard	Current US GAAP	Current IFRS
<p>Services provided by intermediaries:</p> <p>In step 2, an intermediary will need to evaluate the terms of the contract and its customary business practice, in order to identify each distinct performance obligation, such as policy placement and claims handling services. The transaction price for the contract is allocated to each distinct performance obligation and recognised when each of the related services is satisfied in step 5.</p> <p>Services other than placement of an insurance policy will need to be documented, performance obligations identified and revenue allocated to distinct performance obligations.</p> <p>The FASB has proposed that it will not require an entity to identify goods or services promised to the customer that are immaterial in the context of the contract, while the IASB decided not to incorporate similar guidance into IFRS 15.</p>	<p>Current guidance requires intermediaries to identify all performance obligations in an arrangement, whether explicit or implicit, and allocate the arrangement consideration to each obligation. Revenue is then recognised in relation to the services performed.</p> <p>The guidance has an exception for services provided which are considered 'perfunctory or inconsequential', for which no revenue is required to be allocated.</p>	<p>IAS 18 requires intermediaries to apply the revenue recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction.</p> <p>Where performance obligations arise from customer business practices but are not contractual in nature, no element of revenue might have been allocated to these obligations. Instead, it is common practice to assess whether there might be a constructive obligation that has to be recognised.</p>
<p>Variable consideration:</p> <p>In step 3, the amount of revenue recorded should take into account the impact of expected cancellations of policies resulting in a 'clawback' of commission. This represents variable consideration and is recognised only if</p>	<p>Revenue is typically recognised net of the provision for expected cancellations. Cancellations are estimated based on historical and/or other market data.</p>	<p>Revenue is typically recognised net of the provision for expected cancellations. Cancellations are estimated based on historical and/or other market data.</p>

New revenue standard	Current US GAAP	Current IFRS
<p>it is highly probable (IFRS) or probable (US GAAP) that there will not be a significant reversal. The impact of cancellations should be considered by type of business based on historical and/or other market data.</p> <p>For potential changes to the transaction price, such as from a change in lapse rates, the constraint for variable consideration also applies.</p> <p>In step 4, the variable consideration can be allocated to a single performance obligation, rather than to all performance obligations in the arrangement, if the following conditions are met:</p> <ul style="list-style-type: none"> • The variable payment relates to a specific performance obligation or outcome from satisfying that performance obligation. • Allocating the variable amount of the consideration entirely to the separate performance obligation is consistent with the amount of consideration to which the entity expects to be entitled for satisfying that performance obligation after considering all other performance obligations and payment terms in the contract. <p>If variable consideration is allocated to a single performance obligation, any changes to the transaction price are allocated in the same manner as at inception (that is, they are allocated to the single performance obligation). Amounts allocated to a satisfied performance obligation (such as placement) would be recognised as revenue, or as a reduction to revenue, in the period in which the transaction price changes.</p>		

New revenue standard	Current US GAAP	Current IFRS
<p>Recognising revenue: In step 5, revenue for placement services (also commonly referred to as ‘commission income’) should be recognised at the point in time when the intermediary has satisfied its performance obligation. Where the only service provided is placement, this would typically occur at the point when the terms of the insurance policy have been agreed contractually by the insurer and policyholder, and the insurer has a present right to payment from the policyholder (the ‘transaction date’).</p> <p>Some contracts combine placement services with other services. For example, for a contract that combines placement services and claims handling services, the placement services fee would be recognised at a point in time, as noted above.</p> <p>Claims handling services are typically performance obligations satisfied over time, as the customer concurrently receives and consumes the benefits provided by the entity’s performance as the entity performs. The period over which revenue relating to the claims handling services should be recognised will depend on the terms of the contract. The terms of some contracts might suggest that claims servicing is required over the coverage and claim settlement periods of the insurance contracts. Other intermediary contracts might be structured such that claims servicing is effectively being provided only over the coverage period (for example, where the intermediary’s obligation to service existing claims would terminate if the policyholder engages a new broker).</p>	<p>Revenue for placement services is recognised when earned and realised or realisable. This is typically interpreted in practice as the effective commencement date of the related policy, but in certain types of arrangements (for example, where the insurer bills the policyholder directly) it might be later.</p> <p>Some contracts combine placement services with other services. For example, for a contract that combines placement services and claims handling services, the placement services fee would be recognised at a point in time.</p> <p>Claims handling service fees are typically earned over time, based on the period over which the intermediary expects to process claims. For example, short-tail claims handling fees are often earned over the period of insurance coverage, whereas long-tail claims handling fees might be earned over the settlement period.</p>	<p>Revenue for placement services is recognised when it is probable that the economic benefit will flow to the entity. This is typically interpreted in practice as being on the effective commencement date of the related policy, but in certain types of arrangements (for example, where the insurer bills the policyholder directly) it might be later.</p> <p>Some contracts combine placement services with other services. For example, for a contract that combines placement services and claims handling services, the placement services fee would be recognised at a point in time.</p> <p>Claims handling service fees are typically earned over time, based on the period over which the intermediary expects to process claims. For example, short-tail claims handling fees are often earned over the period of insurance coverage, whereas long-tail claims handling fees might be earned over the settlement period.</p>

Potential impact

The standard has new requirements for identifying distinct performance obligations and more explicit guidance on recognising revenue as an entity satisfies its performance obligations. As a result, we expect that intermediaries will be taking a fresh look at the various material services that they provide, making an allocation to performance obligations based on the relative stand-alone selling prices, and analysing potential patterns of revenue recognition. Important considerations will include interpretation of what constitutes a 'distinct' performance obligation, and the period and pattern over which a customer receives the benefits of these distinct services.

Contingent and renewal commissions

A number of intermediaries enter into delegated authority agreements with insurance companies – that is, contracts whereby they perform the underwriting of insurance policies for the insurer (including issuance of the policy) in accordance with parameters set by the insurance entity. In exchange, the intermediary is entitled to commission revenue from the customer for placement of the policy (as discussed above) and revenue from the insurer for the underwriting services that they perform.

The consideration received from the insurer is typically variable based on the underlying profitability of the business generated by the intermediary ('profit commission') or the volumes of contracts introduced to the insurer ('volume override'). Therefore, the amount of commissions can be finalised a number of years after the initial policies are written. The ability to determine the amount of the commission is based on the type of business and quality of data available to the intermediary. For example, claim experience in relation to a motor book might be predictable and short tail whilst, for a medical malpractice book, it might be long tail and uncertain.

An intermediary might receive commission payable both at inception of an underlying insurance contract and upon its subsequent renewal(s). One example is an annual property/casualty contract, for which initial and renewal commissions are agreed between the intermediary and the insurer at the start of the initial policy period. The policyholder is not obliged to renew beyond the first annual period. A commission is due to the intermediary at contract inception and at each renewal date.

Another example is a long-duration life insurance contract for which the policy terms are agreed between the policyholder and insurer at the start of the initial policy period but for which the policyholder has the right to cancel. Intermediaries typically receive a significant first-year commission for placing these life insurance policies, and then subsequent lower commissions in future years as long as the policyholder does not cancel or lapse.

The table below focuses on the variable consideration element of the arrangements in step 3. The allocation of the transaction price over the separate performance obligations in step 4 for placement and other services has been discussed in the previous section, 'Placement of an insurance policy and other performance obligations'. For the purposes of the following table, it is assumed that the intermediary has no responsibilities to secure contract renewals or to perform any services or activities under the contract other than initial placement.

New revenue standard	Current US GAAP	Current IFRS
Profit and volume commissions: In step 3, the transaction price relating to profit commissions should be determined based on a best estimate of the variable consideration using either the expected value method or the most likely outcome. However, revenue would only be recorded to the extent that it is highly probable (IFRS) or probable (US GAAP) that it will not be subject to significant reversal.	<p>In general, current US GAAP requires that revenue is recognised when earned and realised or realisable, including consideration of when it is fixed or determinable. However, there is no specific guidance for recognition of contingent commissions.</p> <p>Given the judgement involved in making these determinations, intermediaries have recognised contingent commissions (profit commissions) in a number of different ways. These include recognising revenue when notification of the commission is received from the insurer, on cash receipt, or when the performance threshold has been met</p>	<p>In general, IAS 18 requires revenue to be recognised when the service has been delivered, the amount can be reliably estimated and it is probable that the economic benefit will flow to the entity. However, there is no specific guidance for recognition of contingent commissions.</p> <p>Given the judgement involved in making these determinations, intermediaries have recognised contingent commissions (profit commissions) in a number of different ways. These include recognising revenue when notification of the commission is received from the insurer, or recognising revenue on cash receipt, based on arguments that</p>

New revenue standard	Current US GAAP	Current IFRS
	and is not subject to reversal. This is based on arguments that this is the point in time when it is fixed or determinable.	this is the point in time when they are able to reliably estimate the contingent commissions. However, in some instances, intermediaries recognise revenue over a number of periods in increasing increments as the certainty of the ultimate estimate increases.
<p>Renewal commissions: In step 5, the performance obligation relating to the initial placement is satisfied at the point when the terms of the insurance policy have been agreed contractually by the insurer and policyholder, and the insurer has a present right to payment from the policyholder (the 'transaction date'). The fact that the commissions received are contingent on a future event does not affect the assessment of whether the performance obligation has been satisfied. Therefore, the transaction price at the transaction date of the initial insurance contract would include both initial commission and expected renewal commissions and would be recognised as revenue at that date, but only if it is highly probable (IFRS) or probable (US GAAP) that there will not be a significant reversal of the revenue for renewal commissions.</p> <p>Consideration of expected lapses during the renewal periods would be included in the estimation of the expected fee.</p>	For a multi-year intermediary arrangement, where the underlying insurance contract has a series of annual renewal dates and the intermediary agreement has annual renewal commissions, the related placement service revenue would typically be earned on each annual renewal date of the underlying insurance contract and, for a long-duration contract on a receipts basis, when it is known that the customer has not cancelled.	<p>IAS 18 requires insurance agency commission received or receivable, relating to intermediary agreements that do not require the agent to render further service, to be recognised as revenue by the agent on the effective commencement or renewal dates of the related contracts. Revenue relating to a property/casualty insurance arrangement with a series of annual renewal dates and commissions is earned on each renewal date.</p> <p>For long-duration life insurance contracts, there are two approaches used in practice for the accounting for renewal commission receivable by the intermediary. Under the first method, revenue is measured by reference to historical data to estimate the amount that is expected to be received over the life of the policy. Alternatively, revenue is recognised each year when it is certain that the customer has not cancelled the policy.</p>

Potential impact

Variable consideration

Revenue relating to contingent profit commissions might in some circumstances be recognised under the new revenue standard earlier than it would have been under existing IFRS or US GAAP. In some instances, even though the performance obligation is satisfied, at the start of the contract an intermediary might conclude that the contingent commission amount is highly susceptible to factors outside its influence, as this is based upon variability of claims incurred by the policyholders, and so significant reversal of revenue might be (highly) probable. However, as time goes on, variable consideration might not be constrained.

The revenue standard might also lead to earlier recognition of revenue than current IFRS or US GAAP in some instances involving renewal commissions, as noted above. That is, where the intermediary has no responsibilities to secure contract renewals or to perform any other activities under the contract, recognition of revenue at initial contract inception, including commissions relating to future expected policyholder renewals, would be appropriate (assuming the variable consideration is not constrained).

The impact of the constraint on variable consideration might be affected by whether it is assessed for an individual contract or for a portfolio. It might be difficult to prove that the revenue for trail commissions upon renewal of the policy is highly probable (IFRS) or probable (US GAAP) of not being subject to significant reversal, because it is not clear whether an individual policyholder will renew its policy. Alternatively, the entity might assess the constraint at the portfolio level, and variable consideration for part of the portfolio might be recognised if it would not be subject to significant risk of reversal. We expect the TRG to discuss this issue at a future meeting.

Performing ongoing services in addition to placement

In many commercial lines of business, the intermediary might be performing ongoing services in addition to original placement. In these instances, recognition of the entire amount of commissions, including any renewal commissions, at initial placement would not be appropriate.

What's next?

The revenue standard is effective for the first interim period within annual periods beginning on or after 1 January 2017 (IFRS), beginning on or after 15 December 2016 (for US GAAP public entities), and for annual reporting periods beginning after 15 December 2017 (for non-public US GAAP entities). However, both the IASB and FASB have proposed to delay the effective date by one year. The IASB plans to continue to allow for early adoption, while the FASB plans to permit entities to adopt as of the original effective date. Entities will have the option to apply the revenue standard retrospectively or use a simplified transition method. An entity will not restate prior periods if it uses the simplified method.

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner.

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