Applying IFRS in Insurance

The new revenue recognition standard - insurance entities

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What you need to know

⦁ Revenue from contracts accounted for under IFRS 4 is outside the scope of IFRS 15.

⦁ Insurance entities will have to apply the new revenue recognition standard to their non-insurance contracts. Furthermore, entities may have to apply the new standard to non-insurance components of contracts traditionally considered to be insurance contracts.

⦁ The new standard’s requirement for accounting for variable consideration could change the timing of revenue recognition for non-insurance contracts issued by insurance entities.

⦁ IFRS 15 is effective for annual periods beginning on or after 1 January 2017, with early adoption permitted.
Overview

The new revenue recognition standard, referred to under IFRS as IFRS 15 *Revenue from Contracts with Customers* (the standard), issued jointly by the International Accounting Standards Board (the IASB) and the Financial Accounting Standards Board (the FASB) (collectively, the Boards) provides accounting requirements for revenue arising from contracts with customers. It affects all entities that enter into contracts to provide goods or services to their customers, unless the contract or a portion of the contract is in the scope of other IFRSs, such as IFRS 4 *Insurance Contracts*. IFRS 15 also includes a model for the measurement and recognition of gains and losses on the sale of certain non-financial assets, such as property, plant and equipment and investment property.

This publication summarises the key implications for insurance entities. Our *Applying IFRS* publication, *A closer look at the new revenue recognition standard* (June 2014), (general publication) provides an in-depth discussion of the new revenue standard. Our *Applying IFRS, The new revenue recognition standard - asset management* (January 2015), provides an overview of asset management-related issues, which may be relevant to insurance entities for their stand-alone asset management business.

Insurance entities may wish to monitor the discussions of both the Boards’ Joint Transition Resource Group for Revenue Recognition (TRG) and a task force formed by the American Institute of Certified Public Accountants (AICPA) to focus on issues related to services provided within the insurance industry. The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG will not make formal recommendations to the Boards or issue application guidance. The AICPA’s insurance industry task force is one of 16 industry task forces the AICPA has formed to help develop a new Accounting Guide on revenue recognition under US GAAP. Any views discussed by the TRG or guidance produced by the AICPA is non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyse the standard and entities begin to apply it. Our views may evolve during that process.
1. Key industry considerations

Insurance entities will continue to apply IFRS 4 to their insurance contracts. However, entities will need to apply IFRS 15 to non-insurance contracts (or components of insurance contracts). Therefore, insurance entities will need to carefully evaluate the scope of the new standard in addition to the requirements that may have a more significant effect on insurance entities (e.g., identifying performance obligations, estimating variable consideration).

1.1 Scope

Insurance entities will need to consider whether IFRS 15 affects how they currently account for non-insurance components of insurance contracts within the scope of IFRS 4 as well as other contracts with customers. Under IFRS 4, entities that issue insurance contracts (insurance entities) generally apply ‘previous accounting’\(^1\) to contracts that are in scope of that standard, without separating any non-insurance components included in the insurance contracts.

The future insurance contracts standard (IFRS 4 Phase II) includes specific requirements for determining non-insurance components and which accounting standard to follow (IFRS 4 Phase II or IFRS 15). Specifically, IFRS 4 Phase II is expected to require insurance entities to separate any non-interrelated\(^2\) services from the insurance contract and account for such services in conjunction with other IFRSs. These services will be accounted for under IFRS 15. However, interrelated components within insurance contracts would not be separated from the insurance contract and thus are expected to remain under IFRS 4 Phase II. Most insurance contracts are not expected to include components that need to be separated and accounted for under IFRS 15.

For fixed-fee service contracts that meet the definition of an insurance contract, IFRS 4 Phase II is expected to provide entities with an accounting policy choice to either apply its requirements or to follow IFRS 15 for those contracts.\(^3\)

Insurance entities may also provide stand-alone services (i.e., services not sold as part of an insurance contract) to their customers. Examples include asset management services, third-party claims administration (TPA) and certain health care services. Such stand-alone service contracts, which are currently accounted for under IAS 18 \textit{Revenue}, will be accounted for under IFRS 15.

Insurance entities may need to change their existing practices for recognising revenue for these contracts, for example, if their contracts have variable consideration.

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\(^1\) The IASB issued IFRS 4 in 2005. This is an interim standard that does not specify a comprehensive accounting model for insurance contracts, but allows insurers to continue to apply their (local) accounting practices that existed upon the adoption of IFRSs (generally referred to as ‘previous accounting’).

\(^2\) Under the draft guidance for IFRS 4 Phase II, a component is interrelated if it can be measured independently from other components of a contract or if a policyholder can benefit from it without the presence of other components.

\(^3\) It is expected that under IFRS 4 Phase II, fixed-fee service contracts will be defined as contracts that have as their primary purpose the provision of services and meet certain conditions.
1.2 Identifying performance obligations

For non-insurance contracts in the scope of IFRS 15, insurance entities may identify performance obligations (i.e., units of accounting) that they previously have not identified. IFRS 15 requires an entity to identify all goods and services promised to a customer by reviewing the contract terms and its customary business practices. This may result in an entity identifying several distinct services when it enters into a contract with a customer to perform a variety of activities (e.g., a TPA arrangement that includes insurance claims processing and administration services, integrated disability management programmes, information risk management services, risk/loss control consulting services and/or property appraisal services). An entity will then evaluate whether the separate services should be accounted for as a single performance obligation or multiple performance obligations.

Under IFRS 15, a series of distinct goods or services that is transferred consecutively is treated as a single performance obligation if the distinct goods or services are substantially the same and would be recognised over time using the same measure of progress. Certain services provided by insurance related TPAs (e.g., claims processing, contract administration services) under a contract are substantially the same and occur continuously over the contract period. These types of services will generally represent a single performance obligation comprising a number of discrete service periods (e.g., months, quarters, years).

1.3 Determining the transaction price

The transaction price (consideration to which the entity expects to be entitled) in non-insurance contracts may vary in amount and timing as a result of per-unit pricing, discounts, ‘clawback’ provisions, incentives or performance bonuses. IFRS 15 requires that an entity estimates, at contract inception, the variable consideration to which it expects to be entitled. It includes in the transaction price, an amount for which the entity has determined that it is highly probable that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved (referred to as the constraint on variable consideration).

When applying the constraint on variable consideration, entities will have to assess any provisions that change the initial amount of consideration. Such provisions are common in insurance brokerage (clawback) or TPA arrangements (adjustment of provisional rates). For example, if an initial TPA monthly claim processing fee is based on provisional expected claims volume, the monthly per-claim fee is subsequently adjusted to reflect actual claim volumes and causes the contract consideration to be variable.

Under IFRS 15, insurance entities and brokers will have to include in the transaction price the portion of contingent amounts for which they determine that it is highly probable that a significant reversal will not occur when the uncertainty is resolved. This means that they may determine it is appropriate to recognise some portion of these amounts before the contingencies are resolved. For example, an insurance broker’s compensation arrangement often will include entitlement to a percentage of renewal premiums when a customer extends its existing insurance contract (i.e., renews the contract). These commissions are referred to as trailing commissions. Entities will have to estimate the future trailing commissions as part of the variable consideration and include such estimates in the transaction price (subject to the constraint).

Insurance entities will have to update the transaction price each reporting period to reflect adjustments in expected consideration.
If an entity determined the contract includes more than one performance obligation, the transaction price will need to be allocated to the individual performance obligations (see also next section).

IFRS 15 will change the constraints on the amount of revenue that can be recognised and could result in revenue being recognised earlier than under today’s accounting. For example, under IAS 18, uncertainties may prevent the outcome of the transaction from being measured reliably and result in the amount recognised being limited to the recoverable expenses incurred. Under current IFRS, considerable judgement is needed when deciding if the outcome of the transaction can be measured reliably. Similarly, the application of IFRS 15 will require judgement.

1.4 Allocating the transaction price to performance obligations
Insurance entities will have to determine the transaction price for a contract and generally allocate this transaction price to each of the performance obligations on a relative stand-alone selling price basis. This may be challenging for entities to assess when a single insurance contract also contains non-interrelated services. For example, an entity may charge one premium for a contract that has significant insurance risk, but also contains non-interrelated asset management services. Once the asset management component is separated, the insurance component will be accounted for under IFRS 4 with the asset management component being accounted for under IFRS 15. Allocating the combined premium to the two components may be a new challenge for insurers.

How we see it
Insurance entities will likely need to involve personnel beyond those in the accounting or finance departments, such as those involved in an entity’s pricing decisions, especially when contracts include service components that need to be separated from the insurance contract and accounted for under IFRS 15.

When performing such an assessment, insurance entities should be aware that the unit of account in IFRS 15 (i.e., an individual performance obligation) is likely to be more granular than the unit of account applied in the existing and future insurance contracts standards.

Entities will need to determine whether variable fees for certain claims processing and administration services in multi-period contracts need to be allocated entirely to distinct service periods that have already occurred (e.g., prior months) once it is highly probable they will no longer be subject to a significant revenue reversal, if the criteria for allocating variable consideration to one or more, but not all, performance obligations or distinct goods or services are met.
1.5 Recognising revenue by satisfying the performance obligation

Under IFRS 15, an entity will recognise revenue when it transfers control of the promised good or service to the customer. This could either be at a point in time or over time. Many of the non-insurance services that insurance entities provide are generally satisfied over time because the customer simultaneously receives and consumes the benefits provided by the insurance entity as it performs the service.

In certain cases, IFRS 15 permits an entity to recognise revenue for the amount it has the right to invoice, if that amount corresponds to the value it transferred to the customer during that period. This practical expedient is available only for the recognition of revenue for performance obligations that are satisfied over time using an output method measure of progress. If an insurance entity qualifies for this practical expedient, the pattern of revenue recognition under IFRS 15 may be similar to current practice (e.g., recognition of revenue on an as-invoiced basis), depending on the entity’s estimates of variable consideration.

2. Next steps

While the effect on insurance entities will vary, many will face some changes in their revenue recognition practices. All entities will need to evaluate the requirements of IFRS 15 and make sure they have processes and systems in place to collect the necessary information to implement the standard, even if the ultimate impact on the accounting is not significant.

Insurance entities should continue to monitor the ongoing discussions of the Boards, the TRG and the AICPA so they can consider the impact of evolving interpretations and application of IFRS 15 to common transactions. Insurance entities should also consider their communications with investors and other stakeholders, including their plan for disclosure of the effects of new accounting standards that are issued but are not yet effective, as required by IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

How we see it

The effective date of the new insurance contracts standard (IFRS 4 Phase II) is likely to be later than the IFRS 15 effective date. With different effective dates, entities will need to evaluate the impact of IFRS 15 while applying the existing insurance standard and reconsider its impact in light of the new insurance contracts standard. In order to manage implementation efforts, insurance entities should consider performing an analysis of the impact of IFRS 15 in respect of both insurance contracts standards.
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