Accounting for revenue is changing

What’s the impact for insurers?

June 2016

The new revenue standard\(^1\) – effective from 1 January 2018 – is likely to affect the way you account for non-insurance revenue. But it is more than just an accounting change.

**It could impact:**

- contracts that fall entirely, or partly, in the scope of the new revenue standard
- unbundling of performance obligations to provide goods or non-insurance services from insurance contracts
- timing of revenue recognition for up-front fees
- deferral and amortisation of costs for non-insurance contracts or components
- measurement and timing of recognition for variable consideration

It’s time to engage, particularly as there are also new standards on financial instruments and leases – as well as the forthcoming insurance contracts standard – to consider.

**If you have:**

- contracts that include insurance and non-insurance components
- contracts to provide non-insurance services
- non-refundable up-front fees
- performance-based incentive fees
- costs related to obtaining and fulfilling contracts

... it’s time to start looking at your contracts and assessing how the new revenue requirements will affect your business.

**Engage with your stakeholders to build expectations of how your KPIs or business practices may change.**

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1. IFRS 15 and FASB ASC Topic 606 Revenue from Contracts with Customers
Determining the impact

Contracts that include insurance and non-insurance components

Potential impact
- Non-insurance service contracts – such as asset management, insurance broking, pension administration, claims handling or custody services – may fall entirely in the scope of the new revenue standard.
- Insurance contracts and contractual rights and obligations in the scope of the financial instruments guidance are fully, or partly, scoped out of the new revenue standard. This is largely consistent with current practice.
- Contracts that are partly in the scope of another standard – e.g. investment management contracts that originate from one or more financial instruments – are first subject to the requirements of the other standard if that standard specifies how to separate and/or initially measure one or more parts of the contract.

Actions to consider
- Review product profiles and consider whether they include performance obligations to provide goods or non-insurance services which fall in the scope of the new revenue standard.
- Analyse at a high level the impact on the amount and timing of revenue recognition.
- Identify data ‘gaps’ between what is presently available and what is necessary to meet the new requirements.
- Think about how to determine which part of the consideration relates to insurance risk and which part relates to other services.

Contracts to provide non-insurance services

Potential impact
- Non-insurance service contracts may integrate different services into a single package – e.g. administrative services, asset management and custody services. IFRS 15 includes new guidance for such arrangements, including:
  - new separation criteria that may affect which services are bundled or unbundled; and
  - new guidance on determining and allocating the transaction price for each performance obligation.

Actions to consider
- Evaluate bundled non-insurance service contracts against the new separation criteria.
- Consider whether any contract terms should be modified for the impact of the new revenue standard.
- Develop systems and processes to allocate a contract’s transaction price to each performance obligation based on its relative stand-alone selling price.

Non-refundable up-front fees

Potential impact
- Accounting for non-refundable up-front fees received at or near inception – e.g. front-end loaded fees received for investment management contracts – will depend on whether the fee:
  - relates to a specific good or service transferred to the customer; or
  - represents an advance payment for future goods and services in the contract, including future contract periods.
- The timing of the receipt of an up-front fee in comparison to the transfer of the services it relates to may give rise to a significant financing component. In this case, the transaction price may need to be adjusted to reflect the time value of money.

Actions to consider
- Assess the impact of the new guidance on the timing of revenue recognition for any non-refundable up-front fees.
- Determine whether the timing of the receipt of a non-refundable up-front fee creates a significant financing component in a contract. If a significant financing component is identified, design processes to measure the time value of money and ensure that your systems can handle the resulting calculations.

Performance-based incentive fees

Potential impact
- Companies may earn performance-based incentive fees for investment management services, which are subject to the variable consideration guidance of the new revenue standard.
- When determining the transaction price, a company estimates the amount of variable consideration using either the ‘expected value’ or ‘most likely amount’ method.
- The estimated variable consideration is included in the transaction price to the extent it is highly probable2 that a significant revenue reversal will not subsequently occur.

Actions to consider
- Consider whether new models or processes are needed to determine the transaction price.
- Evaluate the impact of the new revenue standard on internal management reporting and key performance indicators.

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2. The term ‘highly probable’ has been used in the IFRS version of the new revenue standard with the intention of converging with the term ‘probable’ as used in the US GAAP version of the new revenue standard.
Costs related to obtaining and fulfilling contracts

Potential impact

– Under IFRS 15, a company is required to capitalise certain costs incurred in obtaining and fulfilling a contract, if specified criteria are met. This may include capitalisation of broker commissions payable when an investment contract is obtained.
– Companies can elect not to capitalise costs that would be amortised within a year or less.
– Capitalised costs are amortised on a systematic basis consistent with the transfer of the associated goods and services.
– Judgement will be needed to determine the appropriate period and pattern of amortisation – e.g. whether the amortisation period should include anticipated future contract periods. These may differ from the amortisation period of similar costs incurred to obtain insurance contracts.

Actions to consider

– Assess whether the current capitalisation policy is consistent with the new requirements.
– Make changes to existing systems to capture the costs that will be capitalised and/or to reflect amortisation periods.
– Develop a policy for evaluating capitalised costs for impairment.

Transition

Potential impact

– It may not be straightforward to develop an implementation plan that addresses IFRS 15 as well as the requirements of IFRS 9 Financial Instruments, IFRS 16 Leases and the forthcoming insurance contracts standard.
– IFRS 15 may be adopted retrospectively, by restating comparatives and adjusting retained earnings at the beginning of the earliest comparative period.
– Alternatively, IFRS 15 may be adopted as of the date of initial application, by adjusting retained earnings at the beginning of the first reporting period and disclosing the effect of adoption on each line of profit or loss for the first period of application.

Actions to consider

– Perform a high-level gap analysis to identify potential drivers of changes in accounting for revenue and certain contracts.
– Develop an overall strategy for transition that incorporates all accounting changes expected in the near future and capitalises on any available synergies.

How will IFRS 15 and the forthcoming insurance contracts standard interact?

Given the expected three-year lead time from publication to implementation, the effective date of the forthcoming insurance contracts standard is expected to fall well after that of IFRS 15. Where the scoping requirements of the forthcoming insurance contracts standard differ from current practice, implementation may cause some contracts currently accounted for under IFRS 4 Insurance Contracts to fall wholly, or partly, in the scope of IFRS 15. Such contracts may include:
– certain fixed-fee service contracts – e.g. roadside assistance programmes, capitation and fixed-fee medical service arrangements in the healthcare sector, and equipment and maintenance costs – which are permitted, but not required, to be excluded from the scope of the forthcoming insurance contracts standard; and
– service components – i.e. performance obligations to provide goods or non-insurance services – embedded within some insurance contracts which are distinct and required to be separated from the insurance contract.
Companies will have to address the impact these proposed scoping requirements will have on their current product portfolio when transitioning to the forthcoming insurance contracts standard.

You can find more detailed information about IFRS 15 in our publications Transition to the new revenue standard and Issues In-Depth.
How KPMG can help

A robust assessment phase is critical to laying the framework for a successful project, and it is important to start the assessment early to provide flexibility during the implementation phase. Of course, an assessment phase for an insurer should also consider accounting changes arising from IFRS 9, IFRS 16 and the forthcoming insurance contracts standard. KPMG member firms have developed the following tools and resources to help accelerate the assessment and design phases.

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<td>Initial assessment</td>
<td>Quickscan</td>
<td>A top down summary assessment to identify areas of change and further investigation.</td>
<td>Highlights areas of further investigation to prioritise and focus on.</td>
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<td>Disclosures</td>
<td>Opening the black box: Demystifying IFRS 4 Phase 2</td>
<td>A report setting out the expected presentation and disclosure requirements of the forthcoming insurance contracts standard.</td>
<td>Helps develop understanding of the disclosures, the scale of changes and how your processes and systems will be impacted.</td>
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<td>Detailed assessment</td>
<td>Gap analysis</td>
<td>An analysis of the gaps across the organisation between current policies and the new requirements of the forthcoming insurance contracts standard.</td>
<td>Helps deliver comprehensive gap analysis, which supports programme planning and scoping.</td>
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<td>Financial impact assessment</td>
<td>&quot;What if&quot; models and financial impact methodology</td>
<td>Tools that use cash flow projections to illustrate the underlying impact to financial results and actuarial calculations.</td>
<td>Provides early insight into areas of complexity and high-level estimates of the financial impact.</td>
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<td>Operational impact and data flow</td>
<td>QlikView data flow</td>
<td>A visualisation of the data flow from data sources to the financial statements.</td>
<td>Supports training and understanding. Helps with designing processes and data flows.</td>
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<td>Data requirements</td>
<td>Data taxonomy</td>
<td>An analysis of the data gaps to prepare financial statements under the forthcoming insurance contract standard.</td>
<td>Provides early insight into data gaps and level of complexity. Supports programme planning.</td>
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KPMG’s Insurance practice

KPMG’s Insurance practice is a global network of professionals offering skills, insights and knowledge based on substantial experience. KPMG can identify the issues early and can share leading practices to help avoid the many pitfalls of such projects.

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