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Insurance Spotlight

Intersection Ahead in the Revenue Recognition and Insurance Contracts Projects

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Since guidance is likely to intersect, companies should understand the mechanics of both projects to fully assess the impact of the future accounting standards on current business practices.

The Bottom Line

- The comment period on the FASB's and IASB's (the "boards") revised exposure draft (ED), *Revenue From Contracts With Customers*, ended on March 13, 2012. Only 30 comment letters on the ED were received from the financial services industry; however, insurers are likely to be affected by revenue recognition decisions and will need to monitor and understand that project as well as the insurance contracts project to fully assess the impact on existing business practices.
- Certain fixed-fee contracts that would otherwise meet the definition of an insurance contract are likely to be excluded from the scope of the insurance contracts project and would therefore be accounted for under the principles of revenue recognition guidance instead.
- Recently, the boards intentionally aligned the guidance in the two projects on the unbundling of goods and services and the FASB's premium allocation approach (PAA) model. Such alignment created more potential parallels between the projects than many initially considered likely or even possible.
- The proposed revenue recognition ED may also affect an insurer's fee-based business and could change the amount and timing of revenue recognition for performance-based fees. Companies will be required to consider whether the "reasonably assured" hurdle has been cleared before recognizing certain fee income.
- A final revenue recognition standard is not expected until 2013 and would not be effective earlier than January 1, 2015. Also, the boards have extended the timing for issuing insurance contracts EDs (or a possible IASB review draft) to the second half of 2012, with the effective date of a final standard likely to be aligned with the effective date of the financial instruments standard in 2015 or 2016.

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Beyond the Bottom Line

Because of the potential points of intersection between the insurance contracts and revenue recognition projects, insurers need to understand the accounting for both projects to gauge how significantly the new standards will affect their existing accounting practices. The breadth and severity of the projects' impact on entities will depend, in part, on decisions tentatively made or yet to be made by the boards.

This *Insurance Spotlight* summarizes the key provisions of the revised ED on revenue recognition and highlights pertinent sections of the insurance contracts project along with recent board decisions that may either (1) specify that certain aspects of insurance defer accounting directly to revenue or (2) incorporate revenue recognition principles into accounting for insurance.

The boards' success in drafting virtually converged proposals in the revenue recognition project is unlikely to be repeated in the insurance contracts project. When they are released, the FASB's new and the IASB's potentially revised insurance contracts EDs are expected to contain certain key differences despite the convergence efforts.

Principles of the Revised Revenue Recognition ED

Background

The revised revenue ED outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and would supersede most current revenue recognition guidance. With the comment letter period now closed, the boards plan to consider the feedback, perform extensive outreach activities, and redeliberate various topics before finalizing the revenue recognition standard in 2013.

Key Provisions

The revised revenue ED's core principle is that "an entity shall recognize 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 revenue ED would apply to all contracts with customers except those that are explicitly within the scope of certain other *FASB Accounting Codification* topics.

Contracts within the scope of ASC 944[1] are excluded from the scope of the revised revenue ED. As a result of certain decisions recently reached in the insurance contracts project, however, entities may now refer to revenue recognition guidance to account for certain elements of insurance contracts despite the revised revenue ED's broad scope exception.

The revised revenue ED outlined five sequential steps in recognizing revenue:

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."
5. "Recognize revenue when (or as) the entity satisfies a performance obligation."

In addition, the revised revenue ED requires the capitalization of certain costs associated with obtaining and fulfilling a contract and amends the criteria for recognizing losses on certain onerous performance obligations. Compared with current U.S. GAAP, the revised revenue ED would also require expanded quantitative and qualitative disclosures about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, used in applying the proposal's provisions; and (3) assets recognized from costs to obtain or fulfill a contract with a customer.

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Effective Date and Transition

If finalized as currently drafted, the new revenue standard would be applied retrospectively, with certain optional practical expedients that can be employed during the retrospective application. The effective date of the final standard would not be earlier than annual reporting periods beginning on or after January 1, 2015, for public entities, with a minimum of a one-year deferral for nonpublic entities. Early application would be permitted under the IASB's proposal but not under the FASB's proposal.

For more information, see Deloitte's November 15, 2011, *Heads Up*, which highlights the details of the revised revenue ED, and Deloitte's April 13, 2012, *Heads Up*, which summarizes comment letter themes on the proposal.

Insurance Contracts Scope Exceptions

The boards' tentative decisions on insurance contracts scope exceptions and the unbundling of goods and services would result in the use of revenue recognition principles for certain contracts that may otherwise appear to meet the definition of an insurance contract at first glance.

The boards have 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 an agreement to provide services for an uncertain future event. The fee may not be sufficient to cover the costs of services rendered and would therefore meet the definition of an insurance contract irrespective of any scope exception.

However, the boards have unanimously confirmed the proposal to exclude fixed-fee contracts from the scope of the insurance contracts project. The scope exception would apply to any fixed-fee contract that provides service as its primary purpose if it exhibits *all* of the following characteristics:[2]

1. The contracts are not priced on the basis of an assessment of the risk associated with an individual customer.
2. The contracts compensate customers by providing a service, rather than cash payment.
3. The type of risk transferred by the contracts is primarily related to the utilization (or frequency) of services relative to the overall risk transferred.

Because such contracts would be outside the scope of the guidance on insurance contracts, companies would apply revenue recognition guidance instead.

Contracts that may qualify for the scope exception would include (1) capitation and other fixed-fee medical service arrangements in which the customer is not certain to receive a service from the provider unless certain medical events occur, (2) typical fixed-fee prepaid maintenance and repair contracts, and (3) traditional roadside assistance programs. Although these types of fixed-fee contracts expose their vendors to risk related to uncertain events, they often do not meet the definition of significant insurance risk under current U.S. GAAP.

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 ED and the FASB's discussion paper on insurance contracts. Accordingly, entities would account for such contracts (e.g., product warranties) by using the applicable standard — including revenue recognition in certain instances.

Potential Intersection Points

Certain questions raised by constituents regarding the revenue and insurance projects (e.g., whether the time value of money should be considered and how contract acquisition costs and onerous contracts should be treated) have been similar. Accordingly, the boards have identified various points of potential intersection between the two projects and have considered whether similar accounting should be applied or whether other considerations would justify different accounting treatments.

[2] See "Summary of Board Decisions," October 20, 2011, joint board meeting.

Unbundling Goods and Services From Insurance Contracts

The objective of unbundling is to account for a component of an insurance contract the same way one would account for a stand-alone contract with the characteristics of the unbundled component. Once the boards reach agreement on what should be unbundled, agreement will also need to be reached on what guidance should apply to the unbundled component.

At their February 2012 joint meeting, the boards tentatively confirmed that noninsurance goods and services could be unbundled from the insurance contract on the basis of a modification of the revenue recognition criteria for identifying separate performance obligations. Appendix A highlights application differences between the two projects as a result of the decision.

If an entity unbundles goods and services by using the modified basis of the tentative revenue recognition criteria, the unbundled component could be accounted for under *entirely different* guidance. This is conceptually significantly different than revenue recognition, under which the accounting is potentially different in the context of the *same* guidance.

Because of the nature, relatively short duration, and underlying economics of contracts qualifying for the PAA, accounting for such contracts could result in what is arguably a two-model approach from the FASB perspective, with the PAA model more closely aligning with revenue recognition.

Premium Allocation Approach

The boards continue to avoid a public debate on whether the PAA represents a proxy to the building blocks approach (BBA) or a separate measurement model. However, the boards did reach separate decisions in February on the highly anticipated PAA eligibility criteria. The FASB seems to maintain the majority view that the PAA is a separate model akin to revenue recognition. This view emphasizes the boards' desire to align not only the BBA and PAA models but also aspects of these two models with the revenue recognition project.

Appendix B compares the tentative PAA model with some of the core principles of the revised revenue ED.

Asset Management Fees

The revised revenue ED may affect the timing and recognition of revenue for management fees, a significant source of earnings for many life insurers, by constraining the cumulative amount of revenue recognized in a given period. This aspect of the revenue recognition proposal may prove to be the most significant for the financial services industry.

Management Fees and Performance-Based Fees

The fee structure used by many insurance companies for managing separate accounts or other types of investment vehicles offered to customers generally consists of a mix of base management fees and performance-based fees. While the revised revenue ED is not expected to significantly affect the recognition of base management fees, performance-based fees constitute variable consideration under the revised revenue ED and would only qualify for recognition once reasonably assured.

Currently, under ASC 605-20-S99 (formerly EITF Topic D-96[3]), there are two acceptable methods for recognizing performance-based revenue. Under the first method, performance-based revenue is not recognized until the end of the contract year, when the formula-based compensation becomes fixed. Under the second method, revenue is recognized for the amount that would be due at any point in time, as if the contract was terminated as of the reporting date.

Entities will need to consider whether their current policy on recognizing performance-based revenue would remain appropriate on the basis of the revised revenue ED. Those currently applying the second method could experience a significant change in their revenue recognition pattern since performance-based fees may not be considered

[3] EITF Topic No. D-96, "Accounting for Management Fees Based on a Formula."

reasonably assured under the revised revenue ED. In situations in which the performance-based fee is subject to clawback provisions, revenue may be deferred until long after the fees have been received by the insurance company.

Comment letters on the revised revenue ED indicated that some constituents believe that performance-based fees can be reasonably assured and are therefore not subject to the constraint on the amount of revenue that may be recognized, 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 whether the listed indicators (including volatility in the market place) are determinative of when performance-based fees would or would not be recognized as revenue.

Other Fees and Charges

Insurers may own a broker fund or mutual fund that distributes sponsored products for which it receives front-end loaded distribution or up-front fees. The revised revenue 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 recognized over the service period. This may be a change from current practice.

The revised revenue ED may significantly affect the timing of revenue recognition for fee income since variable consideration can only be recognized when it is reasonably assured.

Further, in some cases insurers pay fees to third parties to distribute their products. Entities have asked about third-party fees as well, specifically whether (1) they meet the proposed definition of incremental costs incurred in obtaining a contract (which would be deferred as an asset and amortized in a manner consistent with the pattern of transfer of services) or are considered costs for fulfilling the performance obligation under the contract (which would be expensed as incurred) or (2) the fees paid to third parties should be excluded from the scope of the revised revenue ED.

For a summary of the feedback received by the FASB on the revised revenue ED's proposal regarding when investment managers recognize revenue, see Deloitte's April 2012 *Asset Management Spotlight*.

Thinking Ahead

Although issuance of the FASB's new ED, and the IASB's reexposed or review draft, on insurance contracts is not expected until later in 2012 and the final revenue standard has been delayed to 2013, insurance companies should start preparing now by:

- Monitoring the status of both projects, exchanging views with others in the industry, and actively participating in discussions with the boards.
- Assessing the potential impact and the level of effort required to implement changes by:
  - Conducting strategic reviews of existing policies and business practices.
  - Evaluating specific contracts to determine the appropriate accounting.
  - Determining the extent of modification that may be required for systems, processes, and controls.
- Rallying organizational persons who need to act and develop a plan to institute training programs.
- Formalizing communications necessary to adopt and sustain effective business practices.
- Developing a roadmap of action steps that aligns with the proposed timeframe.

The extent to which the revised revenue ED and the insurance contracts project will ultimately intersect remains to be seen.

Applying these principles-based standards will involve the use of increased judgment. Accordingly, greater emphasis will be placed on management to establish good processes for which documentation is contemporaneously prepared and carefully reviewed.

Watch for additional publications on the insurance contracts standard as we continue to explore the practical and business implications of decisions reached by the boards.

Other Deloitte Resources

- April 13, 2012, *Heads Up*, "Comments on the Revised Exposure Draft on Revenue Recognition."
- March 2012, *Insurance Accounting Newsletter* (Issue 24), "Old Disagreements and New Delays Make Convergence Uncertain."
- November 15, 2011, *Heads Up*, "FASB Issues Revised Exposure Draft on Revenue Recognition."
- November 2011, *Insurance Spotlight*, "October Roundtable and Joint Meeting Highlights."
- September 2011, *Insurance Spotlight*, "Insurance Contracts — A Look at the Current State of the Convergence Project."

Appendix A — Application Differences Resulting From the Decision to Use a Modification of the Revenue Recognition Criteria

Application Differences	Insights on Points of Intersection
The insurance contracts project, unlike the revenue recognition project, does not specify a list of goods or services that might require unbundling under the standard, primarily because the boards believe that providing such a list might deter entities from performing the necessary evaluation of their specific circumstances to determine whether the unbundling criteria are satisfied.	Claims processing, which is commonly provided with insurance contracts, is an example of a service that may be unbundled. In some instances, as often is the case with health insurance, the claims handling service provided to the policyholder will need to be unbundled on the basis of the criteria developed by the boards. In other cases, such as when the claims handling is simply viewed as an activity the insurer must undertake to fulfill its insurance obligation, the service would not be unbundled.
One of the fundamental requirements of the revenue recognition project is for entities to identify each of the separate performance obligations; goods and services that are not distinct are aggregated. Under the insurance contracts project, only goods or services that are distinct would be unbundled; all other goods or services would be measured as part of the broader insurance contract.	When a component of an insurance contract is unbundled, the insurer needs to allocate the cash flows of the insurance contract between the components. Occasionally, it will be easy to determine the stream of cash flows to which a component belongs. Such determination may be difficult, however, when cash flows are related to more than one component, as is the case with many insurance arrangements. This difficulty may result in greater costs and complexities.
The core principle of the revenue recognition model is to recognize revenue to depict the transfer of control. Under this principle, an entity may account for multiple performance obligations together or individually as long as they have the same "pattern of transfer" to the customer, which will result in the same accounting.	If an entity unbundles a good or service component from an insurance contract, that component could be accounted for under entirely different guidance, such as revenue recognition. If the entity separates a performance obligation under the revenue recognition guidance, the performance obligation should be accounted for differently in the context of the same guidance.

Appendix B — Comparison of Revenue Recognition Principles and the Insurance Contracts Premium Allocation Approach

	Revenue Recognition	Insurance Contracts — PAA
Measurement	Estimate the transaction price on the basis of either the probability-weighted amount or the most likely amount, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled. Entities should update estimates as of each reporting date and if changes occur during the reporting period.	The insurer measures the liability for remaining coverage by using the premium receivable at inception. The liability for incurred claims is measured at the expected (probability-weighted) present value of net cash flows as of each subsequent reporting date and, under the FASB approach, excludes any risk adjustment.
Satisfaction of the Obligation	For performance obligations satisfied over time, measure progress toward complete satisfaction of a performance obligation to depict the transfer of control of goods or services to the customer.	The liability for remaining coverage is ratably reduced over the coverage period. Measurement of the liability for remaining coverage is reduced on the basis of time or on the basis of the expected timing of incurred claims and benefits if that pattern differs significantly from the passage of time.
When to Discount	Discount when the contract has a significant financing element. As a practical expedient, do not account for the time value of money if the period between payment and performance is one year or less.	Discounting and interest accretion should be required in the measurement of the liability for remaining coverage for contracts that have a significant financing component. As a practical expedient, insurers need not adjust the liability for remaining coverage to reflect the time value of money if at contract inception the insurer expects that the period between payment of premium and the satisfaction of the obligation to provide insurance coverage will be one year or less.
Discount Rate	Use a discount rate that is consistent with the rate the entity would use in a separate financing transaction with its customers at inception.	Time value of money would be reflected by using a discount rate that is consistent with the characteristics of the insurance liability, as applicable.
Capitalization of Acquisition Costs	Requires capitalization of certain costs associated with obtaining a contract if those costs are incremental and recoverable. It also requires capitalization of certain costs of fulfilling a contract (not covered by other standards) if specified criteria are met. As a practical expedient, an entity is permitted to recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period would have been one year or less.	The measurement of acquisition costs should include directly attributable costs (for the FASB, limited to successful acquisition efforts only) in a manner consistent with the decisions made under the BBA. Insurers should be permitted to expense all acquisition costs if the contract coverage period is one year or less.
Amortization of Acquisition Costs	Amortization of the capitalized costs would occur in a manner consistent with the pattern of transfer of the goods or services and, in certain circumstances, may extend beyond the original contract term with the customer. All capitalized cost assets are subject to impairment testing if any indicators of impairment exist.	Not applicable because costs are not recognized as an explicit asset. The boards nearly unanimously supported exploration of a proposal made by a FASB board member that acquisition costs should be netted against the liability for remaining coverage under PAA rather than presented as an asset.
Onerous Contracts	Entities that satisfy separate performance obligations in a contract over time and over a period greater than one year are required to determine whether those obligations are onerous. A performance obligation is considered onerous if the lowest cost of settling that obligation is greater than the transaction price allocated to that obligation. This loss would be updated as of each reporting date.	A portfolio of insurance contracts is onerous if (1) the expected present value of the future cash outflow from the contract (plus, for the IASB, the risk adjustment) exceeds the carrying amount of the liability for remaining coverage under the PAA regardless of the contract length and (2) the onerous contract liability is measured on the same basis as the liability for incurred claims (whether discounted or undiscounted). The onerous contract test is triggered by qualitative considerations, and once an onerous contract liability is recorded, it should be updated at the end of each reporting period.
Disclosures	Disclosures are extensive and not specific to any contract or type of contract.	Disclosures are likely to be specific to the type of insurance contracts that the entity issues.

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