APPLICATION OF FRS 5 APPLICATION NOTE G: “REVENUE RECOGNITION” BY INSURANCE INTERMEDIARIES

Guidance issued by the Institute of Chartered Accountants in England & Wales on the interpretation of FRS 5 “Reporting the Substance of Transactions”: Application Note G “Revenue Recognition” and its impact on revenue receivable by intermediaries from the sale of insurance products and services.

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Financial Reporting Standards in the United Kingdom are set by the Accounting Standards Board. The aim of this technical release is to set out the ICAEW interpretation of the application note and assist preparers, auditors and users of financial statements in applying the application note to the measurement of revenue receivable by intermediaries from the sale of insurance products and services.

The technical release should be read alongside the application note. It does not purport to deal with all aspects of the application note, only certain areas where it is considered that additional guidance would be helpful.
INTRODUCTION

1. The purpose of this Technical Release is to set out the interpretation of the Institute of Chartered Accountants in England & Wales (‘ICAEW’) of FRS 5 “Reporting the Substance of Transactions”: Application Note G, “Revenue Recognition” (‘the application note’) in respect of revenue receivable by intermediaries (for example agents, brokers, independent financial advisers and retailers selling third party insurance products) from the sale of insurance products and services. The ICAEW is not responsible for setting Financial Reporting Standards (or application notes to Financial Reporting Standards), which are set in the UK by the Accounting Standards Board (‘ASB’). Our role includes providing guidance to members on issues where we consider such guidance is necessary and is not provided elsewhere in order to enhance the consistency and/or quality of financial reporting.

2. The ASB issued the application note on 13 November 2003. The adoption of the application note is mandatory for all financial periods ending on or after 23 December 2003. There is currently a range of methods used by intermediaries to recognise revenue from the sale of insurance products and services. Such revenue may include commissions and fees. This technical release sets out the ICAEW interpretation of the application note in order to provide assistance on its implementation by intermediaries involved in the sale of insurance products and services.

3. The technical release looks particularly at the issues arising in respect of the sale of insurance products and services, although it may also be applicable to other similar arrangements, such as those involving long term savings products. It should be read alongside the application note. The technical release does not deal with all aspects of the application note, only certain areas where it is considered that additional guidance would be helpful.

SCOPE OF THE APPLICATION NOTE

4. Paragraph G2 of the application note excludes arrangements “arising from insurance contracts”. Although certain revenue receivable by intermediaries originates from the establishment of an insurance contract between an underwriter and policyholder, the intermediary is acting as agent rather than participating in the contract of insurance. The revenue receivable by the intermediary will in substance arise from a separate agency agreement, rather than from the insurance contract. Accordingly, revenue receivable by intermediaries from the sale of insurance products is not covered by the exemption in paragraph G2. Such revenue falls within the scope of the application note.

BASIC PRINCIPLES OF THE APPLICATION NOTE
5. The application note sets out basic principles in paragraphs G4 to G10. Principles considered to be of particular relevance to intermediaries involved in the sale of insurance products and services are reproduced below:

G4. A seller recognises revenue under an exchange transaction with a customer, when, and to the extent that, it obtains the right to consideration in exchange for its performance. At the same time, it typically recognises a new asset, usually a debtor.

G5. When a seller receives payment from a customer in advance of performance, it recognises a liability equal to the amount received, representing its obligations under the contract. When the seller obtains the right to consideration through its performance, that liability is reduced and the amount of the reduction is simultaneously reported as revenue.

G6. A seller may obtain a right to consideration when some, but not all, of its contractual obligations have been fulfilled. Where a seller has partially performed its contractual obligations, it recognises revenue to the extent that it has obtained the right to consideration through its performance.

6. The section “Presentation of turnover as principal or as agent” (G60 – G72) may also be of particular relevance to intermediaries involved in the sale of insurance products and services.

**CONTRACTS PROVIDING PLACEMENT SERVICES ONLY**

7. The application note defines performance as “the fulfilment of the seller’s contractual obligations to a customer through the supply of goods and services”. Where the contractual obligations of an insurance intermediary are limited to providing placement services, the appropriate recognition point for revenue is normally at the inception of the policy, since this is normally the point at which the right to consideration is obtained. Where the contractual obligations have been performed and the right to consideration has been established prior to the inception of the underlying policy, such as at the point of sale, revenue should be recognised at that earlier date. It would, however, be unusual for the right to consideration to be achieved before the underlying contract between the principles is in force. Such revenue recognition should be subject to a reduction in revenue in respect of provisions for amounts likely to be repayable on cancellation of policies on a best estimate basis and subject to paragraph 8 below.

8. Intermediaries should, however, consider whether the contractual placement services have been fully performed at the point of inception. In most cases, certain elements of placement activity will not be performed until after inception, such as the provision of policy wordings and certain other administrative matters. In these cases, deferral of the relevant proportion of revenue is appropriate unless the amounts involved would be insignificant.
POST PLACEMENT ACTIVITIES

9. Revenue should be allocated to post placement activities where those activities represent contractual obligations. It will therefore be important for insurance intermediaries to consider which services are provided under contractual obligations and, having regard to the principles set out in paragraph 5 above, allocate revenue to any contractual post placement obligations on a fair value basis unless the amounts involved would be insignificant.

PAYMENT OF PREMIUMS BY INSTALMENT

10. Where insurance contracts placed involve fixed or minimum premiums payable in instalments, revenue on such contracts should be recognised when the right to consideration in exchange for performance arises in accordance with paragraph 7 to 9 above, not as instalments are payable. Revenue should be recognised at the present value of expected cash inflows where the effect of the time value of money is material. Any resulting debtors and creditors created for premium instalments payable should be shown gross on the balance sheet.

BINDING AUTHORITIES AND TREATIES

11. For binding authorities where the amount of an intermediary’s revenue depends on premiums for risks attaching during the life of the policies, revenue should be recognised as premiums attach. Before that point, the intermediary does not have the “right” to the consideration relating to those premiums.

12. For treaties placed where the amount of an intermediary’s revenue over and above that arising on the minimum premium depends upon risks attaching during the life of the treaties, revenue arising upon this element should be recognised as additional premiums attach and a reliable estimate can be made. Before that point, the intermediary does not have the “right” to the consideration relating to those additional premiums.

MULTI-YEAR CONTRACTS

13. The substance of multi-year contracts should be examined to assess whether they are genuine multi-year contracts or merely “umbrella” contracts for a series of annual policies. In respect of a multi-year contract where the terms of the policy are fixed for the full period the scenario is the same as for a shorter term contract, with revenue being recognised on inception and in accordance with paragraphs 7 to 9 above. However, where in substance a multi-year contract represents a series of annual policies, revenue should be recognised according to the inception of the annual policies. Where the multi-year contract contains a cancellation clause, particular attention should be paid to the commercial substance of that clause in the context of the contract as a whole to ensure that the appropriate proportion of revenue is recognised. In some cases, that might lead to the conclusion that a multi-year contract with a cancellation clause in substance represents a series of annual policies.
PROFIT AND VOLUME RELATED REVENUE

14. Where an insurance intermediary receives profit related revenue, such revenue should be recognised only when the right to consideration is achieved and is capable of reliable measurement. The right to consideration might be reached while measurement of this right remains uncertain. FRS 18 requires that under conditions of uncertainty, financial information is prudently prepared. Prudence requires that profit related revenue is recognised only at the minimum value of possible results while significant uncertainty remains. It would be unusual for revenue to be recognised above the minimum value before the underwriting profit on the underlying policy emerges and is capable of reliable measurement.

15. Where the right to volume related revenue becomes due only upon achieving certain thresholds or hurdles, that revenue should be recognised only as those targets are reached.

ADDITIONAL MATTERS FOR LIFE INSURANCE AND OTHER SIMILAR PRODUCTS AND SERVICES

16. Intermediaries typically earn three types of revenue from the sale of life insurance and other similar products and services: initial revenue, trail revenue and renewal revenue. Trail revenue is payable over the life of a contract, subject to there being no lapse, and renewal revenue is paid upon the active renewal of policies. In the unusual event that an intermediary has contractual obligations beyond the inception of a life insurance or other similar product or service, paragraph 9 above will be applicable.

17. Initial revenue may include a claw-back clause, which would require the intermediary to repay parts of the initial revenue in the event of a policy lapse. This is often referred to as indemnity commission. The appropriate recognition point for initial indemnity commission is normally at the inception of the policy, since this is normally the point at which the right to consideration is obtained. Such revenue recognition should be subject to a reduction in revenue in respect of provisions for amounts likely to be clawed back on a best estimate basis.

18. Where the initial revenue is paid over a number of years and subject to the policy remaining in place, this is in substance the same as trail revenue, since the right to consideration depends upon the maintenance of the policy in force, a contingent future event. The revenue should be recognised as set out in paragraph 19 below.

19. Trail and renewal revenue received by intermediaries over the life of a policy should be accounted for as the right to consideration arises, i.e. as each target date is passed without policy lapse or upon renewal. This reflects the fact that the right to receive such revenue is dependent upon a future contingent event. Revenue should be recognised only when that contingent future event is no longer contingent, i.e. it has occurred or become virtually certain.

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