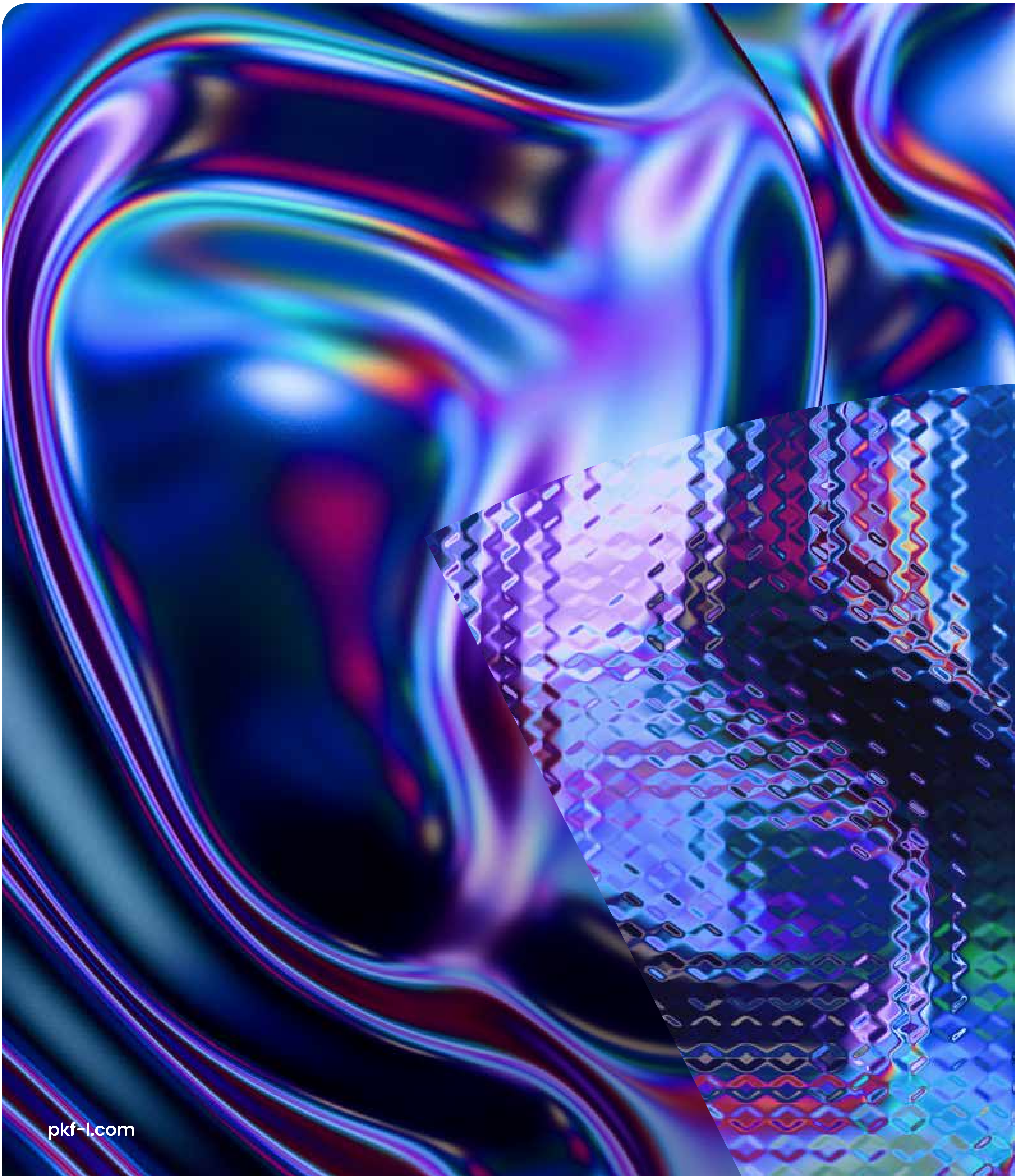
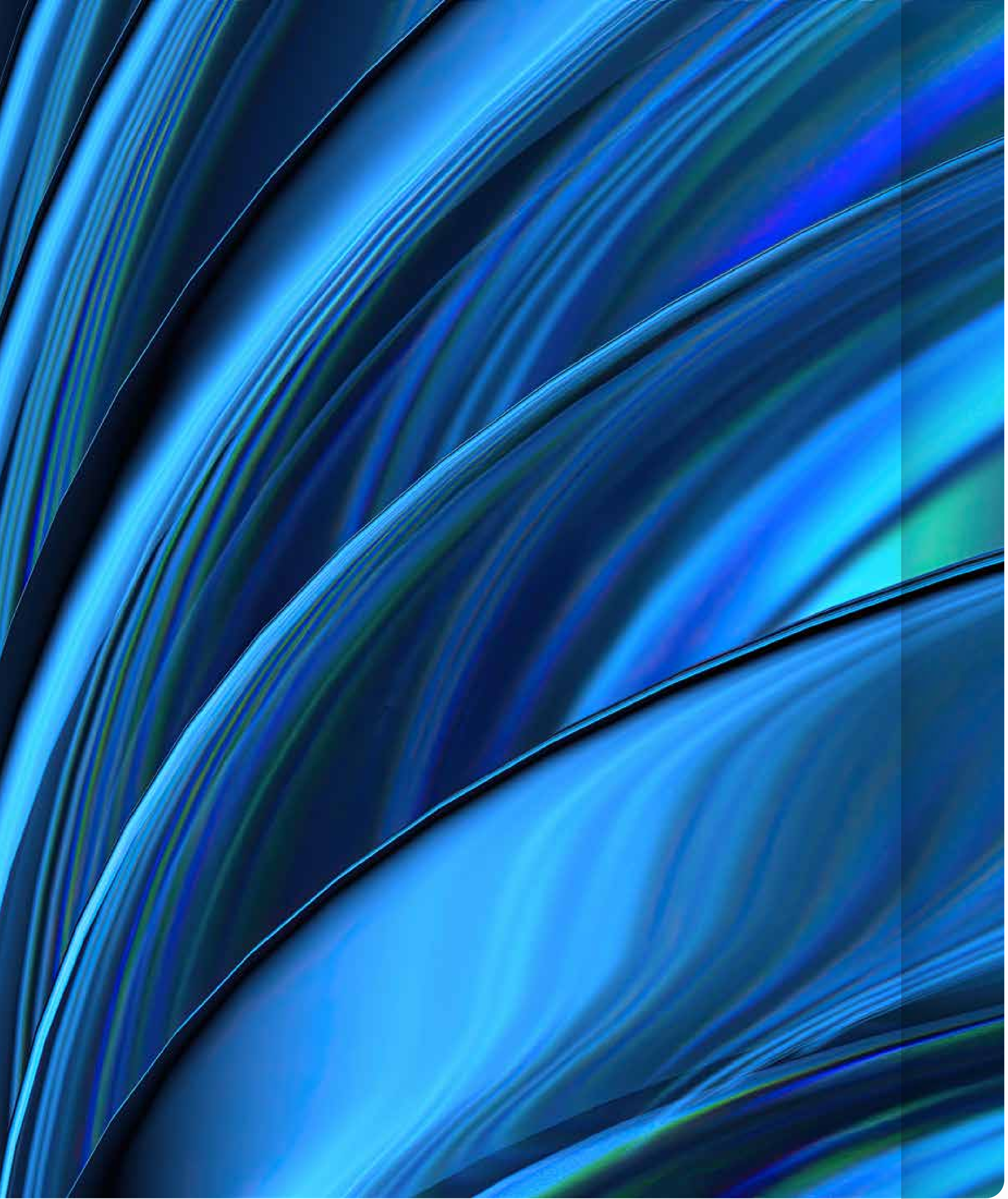
# **Insurance Intermediaries:** A guide to revenue recognition under FRS 102





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# Introduction 01

In March 2024, the FRC made amendments to FRS 102. These include a new model of revenue recognition based on IFRS 15, a new model of lease accounting based on IFRS 16 and various other incremental improvements and clarifications – all of which will impact insurance intermediaries. The revised standard is applicable from 1 January 2026.

## Revenue recognition

Revenue recognition will potentially have the biggest impact on insurance intermediaries. Under the FRS 102 amendments, you will need to assess contracts to determine the timing and amount of revenue to be recognised as follows:

- Services, other than contract placement ie underwriting and claims handling will need to be identified and documented, and revenue allocated to those separate services
- Revenue recognition may be accelerated in instances where an intermediary is entitled to contingent or renewal commissions, and there are no further contractual or implied services to be performed in the renewal periods
- In instances where intermediaries perform ongoing post-placement services such as claims management, policy administration and customer care, recognition of all the commissions up-front at initial placement would be inappropriate
- Under certain broking arrangements such as marine, reinsurance excess of loss and quota share treaties, there will be a need for the best estimate of profit and volume-based commission to be determined up-front and included in the transaction price
- Incremental costs to obtain a contract are likely to be an area of judgment if the entity elects to capitalise those costs.

## The impact

As a result, insurance intermediaries' reported results will change, impacting EBITDA and therefore commercial considerations such as staff bonus arrangements, loan covenant compliance, deferred consideration calculations, valuation and investor performance reviews.

These changes are significant, and management should consider performing an impact assessment, engaging with investors and other business partners to understand the impact of revenue recognition changes to contractual terms, and consider the data requirements.

## PKF is ready to support you

PKF is ready to support insurance intermediaries. We can help you evaluate the impact of the impending changes on your financial reporting and your business, navigate the transition to FRS 102 and beyond, drawing on our technical accounting expertise and in-depth understanding of the insurance intermediary market.

## The five-step model

The key change is the introduction of a comprehensive five-step model for revenue recognition for all contracts aligns with IFRS 15, but with some simplifications.

The five steps are:

**01**
Identify the contract(s) with a customer

**02**
Identify the performance obligations in the contract

**03**
Determine the transaction price

**04**
Allocate the transaction price to the performance obligations

**05**
Recognise revenue when (or as) the entity satisfies a performance obligation.

# The five-step model 02

## Step 1 - Identify the contract(s) with a customer

To identify the contract(s) with a customer, an intermediary could apply the requirements to a portfolio of similar contracts (or performance obligations) if the intermediary reasonably expects that the result of doing so would not differ materially from the result of applying this section to the individual contracts (or performance obligations) within that portfolio.

Determining when the use of a portfolio approach is appropriate may require judgement depending on consistency of contracts and business practices with customers. An intermediary will need to use estimates and assumptions that reflect the size and composition of the portfolio when using a portfolio approach.

## Step 2 - Identify the performance obligations in the contract

A performance obligation is defined as a promise in a contract with a customer to transfer to the customer either:

a. A distinct service (or distinct bundle of services); or
b. A series of distinct services that are substantially the same and that have the same pattern of transfer to the customer.

Understanding and identifying the performance obligations in a contract is essential to determining the timing of revenue recognition under the five-step approach. A contract with a customer generally explicitly states the services that an intermediary promises to transfer. However, promises may be implied by an entity's customary business practices, published policies or statements if these create a valid expectation with the customer.

Performance obligations do not include activities that an intermediary must undertake to fulfil a contract unless those activities transfer a service to the customer. A distinct service is one that is promised by an entity to a customer and meets both of the following criteria:

a. The customer can benefit from the service either on its own or together with other resources that are readily available to the customer; and
b. The entity's promise to transfer the service is separate from other promises in the contract.

To determine if a service is distinct within a contract, the contract terms need to be assessed and the parties' intentions understood.

## Step 3 - Determine the transaction price

Intermediaries need to consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which the intermediary expects to be entitled in exchange for transferring the services promised to the customer, excluding amounts collected on behalf of third parties. In determining the transaction price, an entity shall assume that the services will be transferred to the customer in accordance with the existing contract and that the contract will not be cancelled, modified or renewed.

**Variable consideration**

The transaction price may include variable or contingent consideration, dependent on future events like policy cancellations, lapses, renewals, business volume or claims experience. If the contract includes variable consideration an entity shall estimate the variable amount in the transaction price that reflects the amount of consideration to which the entity will be entitled.

Intermediaries must select one of the following methods to estimate the amount of variable consideration, the method selected must be the method the intermediary expects to better predict the amount of consideration to which it will be entitled:

- The expected value method: The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts.

- The most likely amount method: The most likely amount is the single most likely amount in a range of possible consideration amounts (ie, the single most likely outcome of the contract).

The **expected value method** may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics. Whereas the **most likely amount method** may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (eg, a performance bonus is achieved or not).

The assessment of which model to use should consider the terms of the contract and all reasonably available information, including current, historical, and forecast information. The FRC expects that the information that an intermediary uses to estimate the amount of variable consideration would typically be like the information that management uses in establishing prices for the services promised to the customer. The approach used is not an accounting policy choice and the method should be applied consistently throughout the contract period.

The intermediary shall include in the transaction price an amount of variable consideration only to the extent that it is **highly probable** that it will be entitled to the cumulative amount of revenue recognised – ie, a change in estimate of the variable consideration will not lead to a significant reversal of the cumulative revenue recognised. Significant judgment may be needed to determine whether variable consideration is at risk of significant reversal. Management should perform an assessment considering a range of factors (market, historical experience, length of time) to determine whether the variable consideration will be subject to significant reversal. If a minimum amount of variable consideration is identified that is not expected to be reversed this should be recognised.

# The five-step model

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### **Step 4** - Allocate the transaction price to the performance obligations

At inception of the contract the intermediary needs to determine the stand-alone selling price of the distinct services that are identified as performance obligations and allocate the transaction price in proportion to those stand-alone selling prices. The best evidence of a stand-alone selling price is the observable price of a service when the entity sells that service separately in similar circumstances. If a stand-alone selling price is not directly observable, an intermediary will need to apply judgement to estimate the value of the services.

The intermediary must allocate discounts or variable consideration to all the performance obligations in the contract on a relative stand-alone selling price basis, unless this basis does not depict the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation in the contract. In that case, the entity shall allocate that discount or variable consideration using a method that reflects such an amount (eg, a variable payment may be allocated entirely to one performance obligation in the contract if the terms of that variable payment relate specifically to the entity's efforts to satisfy that performance obligation).

At the end of each reporting period, the intermediary shall update the estimate of variable consideration included in the transaction price to reflect any relevant changes in circumstances. To account for changes in the estimate of the transaction price, the intermediary shall allocate any changes to performance obligations in the contract on the same basis as at contract inception.

### **Step 5** - Recognise revenue when (or as) the entity satisfies a performance obligation

Revenue is recognised when (or as) the entity satisfies a performance obligation by transferring a promised service to a customer. A service is transferred when (or as) the customer obtains control of that service. At contract inception the intermediary needs to determine whether the performance obligation is satisfied over time or satisfied at a point in time, this should be reassessed only if there is a contract modification that substantially changes the performance obligation.

# What are the accounting challenges for intermediaries?

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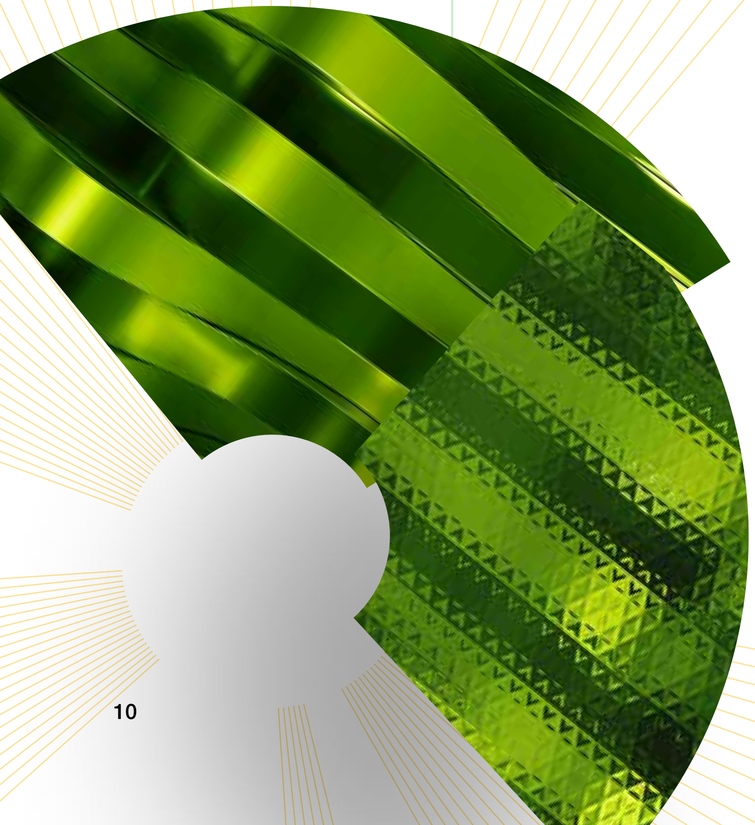
An intermediary will need to evaluate the terms of the contract and its customary business practice, to identify each distinct performance obligation, such as policy placement and claims handling services. Performance obligations will need to be identified, services will need to be documented, and revenue allocated to distinct performance obligations. Below we consider some of the common services and the potential implications.

| Performance obligation | Current FRS 102 accounting | Revised FRS 102 accounting | Complexity of change |
|---|---|---|---|
| **Placement services** ('commission income') | Revenue for placement services isrecognised when it is probable that the economic benefit will flow to the entity.<br><br>This is typically interpreted in practice as being the later of the policy inception date and the transaction date.<br><br>In certain types of arrangements – ie. where the insurer bills the policyholder directly – it might be later. | Revenue should be recognised at the point in time when the intermediary has satisfied its performance obligation.<br><br>Where placement is the only service provided, this would typically occur at the point when the terms of the insurance policy are contractually agreed by the insurer and policyholder, and the insurer has a present right to payment from the policyholder.<br><br>Where placement includes some subsequent policy admin and customer care see **Post placement services** below. | Intermediaries should consider whether the contractual placement services have been fully performed at the point of inception / transaction date.<br><br>In most cases, certain elements of placement activity will not be performed until after inception. The intermediary will need to determine whether such services (provision of policy wordings and certain other administrative matters) are separate performance obligations that require an amount of revenue to be recognised later when such services are provided. |







| Performance obligation | Current FRS 102 accounting | Revised FRS 102 accounting | Complexity of change |
|---|---|---|---|
| **Post placement services** ie, policy admin and customer care | Depends on the significance of the services. Where the services are considered significant a proportion of the revenue is sometimes deferred over the relevant period. | If the services are considered separate performance obligations, they would be accounted for over time, as the performance obligation is satisfied. The intermediary will need to determine the selling price for these services.<br><br>However, it should be noted that set-up activities and administrative tasks which do not transfer a good or service to the customer would be disregarded for the purposes of identifying performance obligations in a contract. | Intermediaries will need to fully understand the terms and conditions of the contract to identify the performance obligations and when the obligations are satisfied.<br><br>Where services do not have a standalone selling price, it will require judgement to estimate the proportion of commission revenue that is associated with the post placement services. |
| **Post placement services - Claims handling**<br><br>The performance obligations for claims handling services are satisfied over time.<br><br>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 and the claims handling services over the life of the performance obligation. | Claims handling fees are typically earned over time, based on the period over which the intermediary expects to process claims.<br><br>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. | The revenue recognition will depend on the terms of the contract. Some contractual terms might indicate that claims servicing is required over the coverage and claim settlement periods of the insurance contracts.<br><br>Other contracts might be structured in such a way that claims servicing is effectively being provided only over the coverage period - ie, if the performance obligation to service claims terminates if the policyholder engages a new intermediary. | The terms and conditions of the contracts need to be fully understood to identify when the performance obligations are satisfied.<br><br>Depending on the terms of the contracts and the existing accounting policy. There could be some changes that need to be considered that results in changes to revenue recognition under the amendments. |

| Performance obligation | Current FRS 102 accounting | Revised FRS 102 accounting | Complexity of change |
|---|---|---|---|
| **Profit and volume related commission** (variable consideration) | Revenue is required to be recognised when the service has been delivered, the amount can be measured reliably, and it is probable that the economic benefits will flow to the entity. There is however no specific guidance for recognition of contingent commissions. As a result, there is mixed practice in the market regarding the recognition of profit commissions.<br><br>Examples include:<br><br>• Recognition when notification of the commission is received from the insurer<br>• Recognition when the cash is received. This is when the intermediary can reliably estimate the contingent commissions<br>• Recognition of the contingent commission over the life of the contract adjusted as the certainty of the estimate increases. The asset recognised would be adjusted at each reporting period where relevant evidence indicates a change<br>• Recognition net of the provision for expected cancellations. Cancellations are estimated based on historical and/or other market data. | Variable commission is only recognised if it is highly probable that the performance obligations will be satisfied and that there will not be a significant reversal of the cumulative revenue recognised.<br><br>Variable consideration needs to be estimated using either:<br><br>• The expected value method; or<br>• The most likely amount method.<br><br>The intermediary needs to select the method that best predicts the amount of consideration to which the intermediary will be entitled.<br><br>If at inception an amount is identified as highly probable, with no significant expectation of reversal, the intermediary will need to recognise the amount and allocate it to performance obligations.<br><br>If an amount of variable consideration is recognised, it should be reviewed at the end of each reporting period. The intermediary shall update the estimate of variable consideration included in the transaction price to reflect any relevant changes in circumstances.<br><br>Variable consideration can be allocated to one performance obligation or multiple obligations at inception. Where there are any changes to the transaction price, the changes are allocated consistent with previous allocations. | Intermediaries will need to fully understand and document the performance obligations and contingent events relating to the variable commission – ie, lapses / renewals, policy cancellations, business volumes or claims experience.<br><br>Management will need to exercise judgement in their assessment of whether variable consideration will be subject to significant reversal. These judgements will need to be cleared with the auditors.<br><br>Depending on the current accounting policy, historical commission data and the complexity of the arrangements, the amendments relating to variable commission could prove to be a significant challenge for some finance teams that are not used to forecasting commissions with accuracy. |





| Performance obligation | Current FRS 102 accounting | Revised FRS 102 accounting | Complexity of change |
|---|---|---|---|
| **Renewal commission** | Where the intermediary agreement does not require the intermediary to render further service, revenue is recognised on the effective commencement or renewal dates of the related contracts. Revenue relating to a series of annual renewal dates and commissions are earned on each renewal date. This is common for property/ casualty insurance arrangements. | This is also a type of variable consideration and therefore as above is only recognised if it is highly probable that the performance obligations will be satisfied and that there will not be a significant reversal of the cumulative revenue recognised. | Intermediaries will need to fully understand and document the performance obligations and contingent events relating to the variable commission – ie, lapses / renewals and policy cancellations.<br><br>Management will need to exercise judgement in their assessment of whether variable consideration will be subject to significant reversal. These judgements will need to be cleared with the auditors.<br><br>An estimate of the variable consideration to be recognised will need to be determined and consistently recognised. |

| Performance obligation | Current FRS 102 accounting | Revised FRS 102 accounting | Complexity of change |
|---|---|---|---|
| **Initial revenue with indemnity commission** | Initial revenue may include a claw-back clause, requiring the intermediary to repay some of the initial commission in the event of a policy lapse. This is often referred to as 'indemnity commission'.<br><br>Indemnity' commission should normally be recognised at the inception of the policy, since this is the point at which the right to consideration is obtained.<br><br>As such, revenue should be reduced by a provision for amounts likely to be clawed back on a best estimate basis.<br><br>Some are also recognised on a cash basis, in particular where the premiums are paid directly by the insured to the underwriter, who will subsequently send commission, to the insurance intermediary. | The performance obligations need to be identified. The indemnity commission is variable consideration. Variable consideration is only recognised if it is highly probable that the performance obligations will be satisfied and that there will not be a significant reversal of the cumulative revenue recognised.<br><br>Variable consideration needs to be estimated using either:<br><br>• The expected value method; or<br>• The most likely amount method.<br><br>The intermediary needs to select the method that best predicts the amount of consideration to which the intermediary will be entitled.<br><br>Revenue is recognised as the performance obligations are satisfied. The portion of the transaction price that includes the indemnity commission is recognised in line with the satisfaction of the related performance obligations.<br><br>In the event of a policy lapse the indemnity commission must be repaid. The entity will need to adjust the transaction price and recognise the repayment as a reduction in revenue. | Intermediaries will need to fully understand and document the performance obligations and contingent events relating to the variable consideration – ie lapses.<br><br>Management will need to exercise judgement in their assessment of whether variable consideration will be subject to significant reversal. These judgements will need to be cleared with the auditors.<br><br>An estimate of the variable consideration to be recognised will need to be determined and consistently recognised. |
| **Trail revenue** (revenue payable over the life of a contract subject to there being no lapse). | Where the initial revenue is paid over multiple years and subject to the policy remaining in place, this is in substance the same as trail revenue.<br><br>The right to consideration depends upon the maintenance of the policy in force, a contingent future event. The trail revenue is recognised when that contingent future event is no longer contingent – ie, as a target date is passed without policy lapse. | The performance obligations need to be identified. For trail revenue, this typically involves ongoing services provided over time.<br><br>The intermediary needs to estimate the transaction price, including any variable consideration such as trail commissions. Variable consideration should be estimated using either the expected value method or the most likely amount method.<br><br>The transaction price should be allocated to the performance obligations based on their relative standalone selling prices. Revenue should be recognised as the performance obligations are satisfied. For trail revenue, this usually means recognising revenue over time as the services are provided. | Intermediaries will need to fully understand and document the performance obligations and contingent events relating to the variable consideration – ie lapses.<br><br>Management will need to exercise judgement in their assessment of whether variable consideration will be subject to significant reversal. These judgements will need to be cleared with the auditors.<br><br>As well as the trail revenue, an estimate of the variable consideration to be recognised will need to be determined and consistently recognised. |
| **Renewal commission** (revenue paid upon the active renewal of policies). | In practice there are two approaches for recognition of renewal revenue.<br><br>1. Renewal revenue is recognised upon renewal. The renewal is a contingent future event, and therefore the revenue should be recognised when that contingent future event is no longer contingent – ie the policyholder has not cancelled renewal.<br><br>2. Revenue is measured by reference to historical data to estimate the amount that is expected to be received over the life of the policy. | If the contract includes initial policy setup and renewal services, the intermediary should estimate the total consideration, including variable renewal commissions.<br><br>The transaction price needs to be allocated to initial setup and renewal services based on their standalone selling prices. Renewal commission revenue will be recognised when the policy is actively renewed.<br><br>If the amounts are variable ie tiered based on the number of policies an estimate will need to be made for the variable consideration and adjusted when the variable amount is known ie when the policies have actively renewed. | Intermediaries will need to fully understand and document the performance obligations and contingent events relating to the variable consideration – ie renewals.<br><br>Management will need to exercise judgement in their assessment of whether variable consideration will be subject to significant reversal. These judgements will need to be cleared with the auditors.<br><br>An estimate of the variable consideration to be recognised will need to be determined and consistently recognised. |

# How we can help...

Our **Financial Accounting Advisory Services team** can help you with impact assessments, implementation and transition to the amended FRS 102 standards. We have a team of accounting specialists, experienced in working with insurance intermediaries and who have experience of IFRS 15 transition and understand the challenges these changes pose. Examples of how we can support you include:

- Reviewing customer contracts
- Unbundling contracts between performance obligations and identifying variable payments and providing guidance on the impact and accounting for those arrangements in areas most likely to be impacted, such as recognition of variable and/or contingent consideration
- Reviewing contracts for inclusion of clauses that could impact upon recognition and advising on the accounting for those contracts
- Providing guidance on the impacts of the changes on key performance metrics, such as EBITDA
- Providing advice on the impacts of the amendments on debt covenants and remuneration schemes, so that changes can be considered on a timely basis
- Reviewing accounting papers, accounting policies and financial statement disclosures for compliance with the requirements of FRS 102, as well as consideration and review of transition options and disclosures.

Please do not hesitate to contact us to discuss how we can support you.





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PKF is one of the UK's largest and most successful accountancy brands.

With over 150 years' experience in the insurance market, PKF has built up a solid and comprehensive reputation as one of a small number of UK accounting firms with in-depth expertise in supporting businesses, their owners and investors across the insurance industry.

Ranked as the largest auditor of insurance intermediaries in the UK and the 7th largest auditor of general insurers, our dedicated insurance team acts for major carriers and syndicates, brokers and MGAs including many businesses harnessing the power of technology to transform the insurance industry.

### How we can help...

- Statutory audit →
- Governance, risk and control assurance →
- Tax →
- Transaction advisory →
- Restucturing →
- Business solutions →





| PKF UK in numbers | Insurance intermediaries in numbers | PKF Global in numbers |
|---|---|---|
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