Revenue from Contracts with Customers – Insurance Industry Considerations

Let's talk about an opportunity.
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Learning Objectives

> Provide an overview of ASU 2014-09, *Revenue from Contracts with Customers* (Topic 606)
> Understand the basic requirements of ASC 606
> Provide an overview of ASC 606’s impact to the insurance industry
> Understand the impact ASC 606 may have on your company or clients
Agenda

- Effectives dates
- Scope
- Overview of the 5-step approach to revenue recognition
- Contract costs
- Impact on the insurance industry
- Principal versus Agent Considerations
- Impact on statutory accounting
- Questions
Effective Dates

> For **public entities**, periods beginning after December 15, 2017

> For **all other entities**, periods beginning after December 15, 2018
Scope

> All entities which report in accordance with US GAAP

> Out of scope – specific types of contracts, including:
  > Insurance contracts
  > Leases
  > Financial instruments
  > Nonmonetary exchanges to facilitate sales to customers
  > Certain guarantees
5-Step Approach to Revenue Recognition

1. Identify the contract with the customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to each performance obligation
5. Recognize revenue as the entity satisfies the performance obligation
1) Identify the contract with the customer

- An agreement with enforceable rights and obligations; written, oral or standard business practice
- Parties have approved
- Goods and/or services can be identified
- Payment can be identified
- Commercial substance
- Collectability is probable
1) Identify the contract with the customer

> Additional considerations:

> Collectability: Based on customer’s ability and intent to pay, considering only credit risk

> How and when to combine contracts

> How and when to account for contract modifications; separate contract or adjustment to original contract
2) Identify performance obligations in the contract

- A promise to transfer goods or services
- Services can be discreet or a series of services which are the same
- Explicit or implicit promises
- Determining whether a promise is distinct
2) Identify performance obligations in the contract

> Distinct promises

> Customer can benefit from the good or service on its own with readily available resources

> Separately identifiable, in the context of the contract

> Promise does not significantly modify other promises

> The good or service is not highly interrelated with other promises
3) Determine the transaction price

> Amount of consideration an entity expects to receive in exchange for the good or service

> Variable consideration: must be estimated at contract inception

> Variability as a result of: discounts, rebates, refunds, incentives, performance bonuses, etc.

> Significant financing component
3) Determine the transaction price

> Variable consideration

> Must be estimated either using a probability weighted approach, expected value, or estimated as the most likely amount

> Constraint: the actual amount should be recognized only if it probable that there will not be a significant revenue reversal in the future

> The initial estimate is revisited each reporting period
4) Allocate transaction price

> Allocation based on relative standalone selling price
> Made at inception with no future adjustments for changes in the selling prices
5) Recognize revenue when (or as) performance obligations satisfied

> Recognize as good or services are transferred to customer control
> Control: An entity’s ability to direct the use and obtain all of the remaining benefits of transferred items
> Recognition at a point in time or over time
5) Recognize revenue when (or as) performance obligations satisfied

> Recognize as good or services are transferred to customer control

> Control: An entity’s ability to direct the use and obtain all of the remaining benefits of transferred items

> Recognition at a point in time or over time
5) Recognize revenue when (or as) performance obligations satisfied

> Over time

> Customer concurrently receives and consumes the benefits provided; or

> Entity’s performance creates or enhances a customer controlled asset; or

> Entity’s performance does not create an asset with alternative use and the entity has the right to payment for progress to date
5) Recognize revenue when (or as) performance obligations satisfied

- Point in time - Control transfers to the customer, indicators:
  - Entity has present right to payment
  - Legal title has been transferred to customer
  - Physical possession has been transferred to customer
  - Risks and reward have been transferred to customer
  - Customer has accepted the asset
Key concepts

- An entity should capitalize incremental costs of obtaining a contract and amortize over the life of the contract.
- Relate directly to a contract that can be identified.
- Enhances the entity’s ability to complete the contract.
- Are expected to be recovered.
The new standard will impact:

- Insurance related entities: agencies, brokers, managing general agencies (MGA) and TPA of insurance companies.
- Industries impacted: Life, Health, P&C, Reinsurance
- Administrative Services Only (ASO)
- Third party extended service warranty contracts
- Asset management services provided by insurance entities
- The standard does apply to insurance companies that provide services that fall under the purview of ASC 606.
Impact on the insurance industry (cont’d)

• Insurance-related entities (MGA, Agents, Brokers, TPAs)
  - Generally provides multiple services to the carrier along with the placement of policies
    - Claims and policy administration services, risk management strategies, property valuation
  - Need to carefully assess each performance obligation
  - Allocation of transaction price will be a significant change
    - Policy placement and claims handling services are included in commission rate
    - Assessment of variable consideration – probability assessment will be new to entities and may not have the technical skill to perform
    - Will require significant change to information systems
Impact on the insurance industry (cont’d)

• Agents vs Brokers
  ➢ Agents represent the carrier
    o Provide multiple services to the carrier
    o ASC 606 likely to have greater impact on agents in providing multiple services to carriers as compared to brokers
  ➢ Brokers represent the policyholder
    o ASC 606 generally may not be applicable (except for reinsurance brokers as they provide multiple services on behalf of both the carrier and/or the reinsurer)
    o Entity may operate as a broker for a specific line of business but as an agent for another line of business.
      ▪ When functioning as an agent and providing multiple services, ASC 606 applies if performance obligations are materially distinct.
Impact on the insurance industry (cont’d)

• Managing general agent (MGA)
  - Performs the ordinary functions of an agent but generally is also empowered with underwriting authority from the insurer
  - Typically has specialized expertise that the insurer does not possess in unusual lines of business (such as surplus lines)
  - Similar to an ordinary agent, the MGA may provide services that may require the allocation of the transaction price to each service; therefore ASC 606 would be applicable
• Reinsurance brokers
  ➢ Generally do not provide services other than facilitating the placement of reinsurance contracts
  ➢ Significant impact relates to profit commissions that are received for the placement of profitable business
    o Recognize revenue based on expected results estimated at each reporting period
    o Revenue often recognized on a cash basis under current guidance
Impact on the insurance industry (cont’d)

• Life insurance agents
  ➢ Commission is earned over multiple years on a single policy
    o Need to assess the probability of renewal (can be done at the portfolio level for homogenous policies)
    o Recognize revenue in year 1, instead of each year for each renewed policy, based on the probability assessment
    o Probability assessment generally done by the carrier but not at the agency level in assessing pricing and reserves for insurance products
    o Probability assessment will also need to be applied to performance bonuses with the revenue recognized similar to commissions
Administrative services only (ASO)

- An ASO is an arrangement where a self-funded employee benefit plan, such as short-term disability, of a large employer is administered by a health or life insurance company for a fee
  - The insurer does not assume any risk under this contract as it is only functioning as a TPA
- Generally, as part of the agreement the insurance company will provide multiple distinct services
- The insurer will need to analyze the various services being provided to determine if the review should be accounted for under ASC 606
  - Contracts to administer claims services from ‘cradle to grave’ or fees based on performance the insurance entity needs to assess the period over which to recognize revenue
• Third party extended *service* warranty contracts
  - An entity needs to assess whether or not, as part of the warranty a service will be provided
    - A service to be provided as determined by the warranty, in addition to the product (good or service) that is sold should be accounted for as a performance obligation
  - A warranty that provides only assurance that the product will function as the parties intended generally does not provide the customer with an additional good or service and should be accounted for under ASC 460, *Guarantees*
    - The longer the coverage period, the more likely it is a performance obligation due to the greater likelihood of a service to be provided
• Asset management services provided by insurance entities
  - Life insurers often sell investment type contracts that are not accounted for as insurance contracts. These may be unit-linked contracts for which the customer pays for the financial instrument issued by the insurer and also for asset management services which reduce the policyholders’ initial deposit, as well as ongoing investment management fees that are drawn upon the periodic account balance of the investment contract.
    - Asset management services that are an integral part of an insurance contract, participating insurance or investment contract are not within the scope of ASC 606 (within scope of ASC 944).
  - Where a life insurance company owns an asset management entity and receives a performance based commission from the entity, the commission earned would fall under the guidance of ASC 606
Principal versus Agent Considerations

• Reporting Revenue Gross versus Net
  • ASU 2016-08 – Did not change the core principle of ASC 606, but clarified the implementation guidance on principal versus agent considerations
  • Determination whether the entity’s promise is to provide the good or service itself (that is, the entity is a principal) or to arrange for that good or service to be provided by another party (that is, the entity is an agent)
  • Principals recognize the revenue in the gross amount of consideration to which it expects to be entitled
  • Agents recognize the revenue in the amount of any fee or commission to which it expects to be entitled
Principal versus Agent Considerations

Reporting Revenue Gross versus Net

- An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer.
- Indicators in determining whether an entity controls the good or service:
  - Primarily responsible for fulfilling the promise to provide the good or service.
  - Entity has inventory risk for the good or service has been transferred to a customer.
  - Entity has discretion in establishing the price for the good or service, however agents may have discretion in pricing.
• Currently there are 3 implementation issues and summary items that have been raised
  ➢ Technical correction to clarify that insurance and investment contracts within the scope of ASC 944 are excluded from the scope of ASC 606
  ➢ Insurance contracts within the scope of ASC 944 could still be partially within the scope of ASC 606 regarding price measurement and would therefore be subjected to further analysis under ASC 606
  ➢ Accounting for 3rd party extended service warranty contracts within the scope of ASC 606
Implementation Issues and Summary

- AICPA Revenue Recognition Task Force for Insurance issued a working draft addressing implementation issues related to applying the scope exception to contracts within ASC 944. Comments were due on the release April 3, 2017.

AICPA RRTF Considerations for Applying the Scope Exception in FASB ASC 606-10-15-2 to Contracts within the Scope of ASC 944
Impact on Statutory Accounting

• Rejected by the NAIC as not applicable to statutory accounting
• But more to come…maybe
Questions