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Revenue Recognition: Insurance Entities and Intermediaries

January 24, 2018

Glenn Saslow

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Today's Speaker

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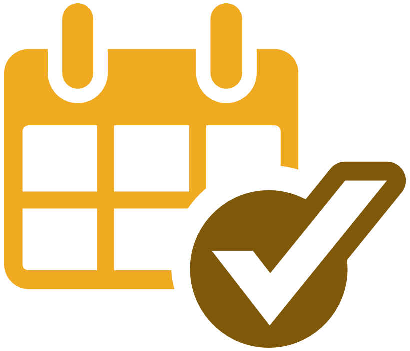
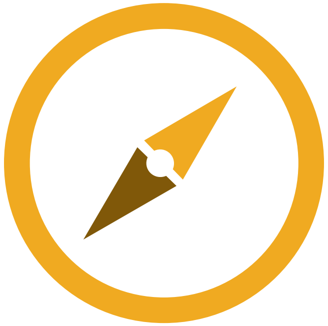
Agenda

- Effective Date and Implementation
- Applicability to Insurance Industry – Scope Exceptions
- Stand Alone Services Provided Outside of an Insurance Contract
- Implications for Third Party Extended Warranty Contracts
- Insurance Intermediaries
- Disclosures and Statutory Accounting Implications



Objectives

As a result of participating in this session, you should be able to:



- List descriptions of the implications of the new revenue recognition standard to insurance entities and intermediaries
- Evaluate whether insurance contracts are within the Scope of ASC 944, the ASC 606, or both
- Discuss the requirements of insurance entities and non-insurance entities writing Third Party Extended Warranty Contracts
- Describe the effects of the new standard on Insurance Intermediaries

Polling Question #1

What type of Insurance organization do you represent ?

A. Property & Casualty

B. Life

C. Insurance Agent or Broker

D. Warranty Company

E. Third Party Administrator

F. None of the above

Effective Date and Implementation

Effective Dates: ASU No. 2014-09 (May 2014)

New Revenue Recognition Guidance Effective Dates	December 31 Year End	September 30 Year End
For PBEs: Fiscal years beginning after Dec 15, 2017, including interim period within	**January 1, 2018**	**October 1, 2018**
For non-PBEs: Fiscal years beginning after Dec 15, 2018, and interim periods beginning after Dec 15, 2019	**December 31, 2019**	**September 30, 2020**

Early adoption is allowed for both PBEs and non-PBEs

Scope Exception for Insurance Contracts

What's In? What's Out?

In Scope

Service Arrangements
Claims Processing
Asset Management

Out of Scope

Life and health insurance
Property and liability insurance
Title insurance
Mortgage guarantee insurance

Insurance Contracts – Scope Exception

- Scope Exception – Excludes insurance contracts within the Scope of ASC 944 – Insurance

ALL contracts with the Scope of Topic 944 are excluded from Topic 606 such as:

a. Life and health insurance
b. Property and liability insurance
c. Title insurance
d. Mortgage guarantee insurance

- Subtopic 944-825 provides guidance for financial instruments including investment contracts – deposit accounting model

- Investment contracts – long duration contracts that do not subject an insurance entity to policyholder mortality or morbidity risk are included with the Scope of 944

Insurance Contracts – Scope Exception

- Scope exception does not apply to all contracts of insurance entities
- Contracts not within the scope of Topic 944
  a. Service arrangements
  b. Claims processing
  c. Asset management
- Bifurcation of Contracts of non-insurance goods and services
- Integrated service components claims handling or asset management services

Insurance Contracts – Bifurcation of Contracts

- Bifurcate contract between Topic 944 and Topic 606
- If contract is entirely within TOPIC 944 the entity would not apply the bifurcation requirements in ASC 606-10-15-4
- If contract is not entirely in the scope of Topic 944 and elements fall under Topic 606 they should apply that guidance
- Fulfillment activities – relate to costs to fulfill the insurance contract
  a. Mitigate risks to the insurer
  b. Contain costs related to services to fulfill the insurers obligation
  c. Not within scope of FASB ASC 606

Fulfillment Activities Performed by Insurance Entities

Activities performed by insurance entities <u>as part of an insurance contract</u> that are NOT within the Scope of 606

- Claims adjudication and processing for high deductible policies
    a. Part of policy premium
    b. Billed separately to policyholder
- Claims processed below the deductible
    a. Mitigate insurers risk of loss above deductible
    b. Holistic view of managing claims from the ground up
- Health Insurance Contracts
    a. Enrollment, provider network access, routine physicals and screening, preventative care, health coaching
- Safety Inspections
- Roadside Assistance
- Cybersecurity Activities
- Title Search

Distinct Performance Obligations – Outside of an Insurance Contract

- Services provided on a stand alone basis <u>outside of a component of an insurance contract</u>
    a. Claims management
    b. Risk management
    c. Financial planning
    d. Financial analysis
    e. Health and safety management
- Identifying separate performance obligations
- Claims adjudication for high and settlement services for a high deductible policy
- Claims management services for a self insurer
- Services with multiple performance obligations
    a. Risk management
    b. Claims management for multiple lines of insurance
    c. Fee for service vs. cradle to grave

Administrative Service Contracts

- Administrative Service Only Contracts Offered with Stop Loss Contracts
  a. Pricing Interdependency - May need to be treated as one contract
  b. Fulfillment of insurance obligation
  c. Not part of fulfillment –
     - Allocate combined consideration for performance obligation to be accounted for under ASC 606
     - Allocate insurance coverage to be accounted for under ASC 944

- Administrative Service Contracts - Health Care Entities
  - ASU 2016-08, “Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations

Polling Question #2

Does your company provide services that are not integrated within an insurance contract ?

A. Yes

B. Yes, but not material

C. No

D. Not applicable

Third Party Extended Service Warranty Contracts – Written By an Insurance Entity

- Extended Warranty Contract that is sold separately from the product

- The FASB master glossary defines an extended warranty contract as "**an agreement to provide warranty protection in addition to the scope of coverage of the manufacturer's original warranty, if any, or to extend the period of coverage provided by the manufacturer's original warranty.**"

- In accordance with FASB ASC 606-10-15-2, an insurance entity should continue to apply the guidance in FASB ASC 944 to warranty contracts that are within the scope of FASB ASC 944 <u>because they are written by an insurance entity.</u>
    a. Insurance subsidiaries of non insurers
    b. Is an obligor an insurance entity?

Third Party Extended Service Warranty Contracts – Not Written By an Insurance Company

- Financial Reporting Executive Committee (FinRec) is reviewing accounting for extended warranty contracts, not written by an insurance entity, that meet the criteria in FASB ASC 606-10-55-31.

- Covers extended warranty contracts that provide services for a fixed fee.
  a. Excludes product maintenance (Not stand ready obligations)
  b. Does not cover extended warranty contracts that only provide for the indemnification/reimbursement of the customer for unscheduled repairs or replacement of the item (i.e., where the company is not obligated to perform a service or engage others to perform a service, but merely to reimburse the customer).

Third Party Extended Service Warranty Contracts – Not Written By an Insurance Company

- ASC 606 differs from the prior extended warranty model applicable under ASC 605-20 (FTB 90-1), which followed an indemnification/provision of coverage type of approach rather than a service model.

- Meets the definition of a Stand-Ready Obligation - contract provides services for unscheduled repairs or replacement of the item under the contract for an unknown quantity of services for a fixed fee

- Earning of revenue
    a. Coverage Period
    b. Performance Period

Third Party Extended Service Warranty Contracts Incremental Costs

- Warranty Contracts Accounted for Under ASC 660
  a. Use ASC 340-40-25-1 which requires that an entity recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs.
  b. Portion of an employee's compensation directly related to contract acquisition are required to be expensed, as those costs would have been incurred regardless of whether the contract was obtained.

- Warranty Contracts Accounted for Under ASC 944 (Insurance Entities)
  a. Use ASC 944-30-25-1A which requires capitalization of acquisitions costs that are either incremental direct or directly related to the successful acquisition of new or renewal insurance contracts.
  b. Directly related costs include the portion of employees compensation related to contract acquisition

Polling Question #3

Have you started to assess the implications of the new revenue recognition standard to your organization

A. Yes

B. No

C. Not sure

D. Not applicable

Insurance Intermediaries

- Compensated by a fee for producing of commission for the placement/brokering of an insurance policy
    a. Introducing policyholder to insurer
    b. Obtaining quotes from insurers
    c. Providing advice on insurers
- Other services include:
    a. Underwriting
    b. Policy administration
    c. Claims processing services
    d. Loss prevention
    e. Risk management
    f. Employee benefits consulting
    g. Captive management services

Insurance Intermediaries

- Current revenue recognition
  a. Based upon stage of completion
  b. When amount it is earned and is realizable
  c. Some entities recognize revenue on the receipt of cash (contingent commission)

- Under ASC 606 - Insurance intermediary needs to recognize revenue as goods and services are transferred to the customer using the amounts it expects to be entitled to in exchange for the services

Insurance Intermediaries

- Identifying the **distinct** performance obligations
- Allocation of transaction price to performance obligations
- Recognition of revenue as each performance obligation is satisfied

Insurance Intermediaries – Revenue Recognition

- Placement Services (Commission income) – Where the only service provided is placement, this would typically occur when the terms have been agreed to and the insurer has a right to payment (the ‘transaction date’).

- Claims Handling Services - typically performance obligations satisfied over time as the customer concurrently receives and consumes the benefits provided by the entity’s performance as the entity performs.
  a. Fee for service
  b. Cradle to grave

Insurance Intermediaries – Variable Consideration

- Variable consideration
  a. Policy cancellations
  b. Lapses or renewals
  c. Volume of business
  d. Claims experience

- Variable consideration should be estimated the method that best predicts the amount of consideration to which the entity will be entitled: the expected value or most likely amount.

- An entity should recognize revenue as performance obligations are satisfied only if it is probable that a change in the estimate of the variable consideration would not result in a significant reversal of the cumulative revenue recognized.

- Allocation of variable consideration to performance obligations

Insurance Intermediaries – Contingent Commissions

- Delegated Authority Agreements – Underwriting of Insurance Policies for carrier
- Profit commissions – Variable based on underlying profitability of business
- Volume override – Variable based on volume of contracts

Insurance Intermediaries – Renewal Commissions

- The fact that the commissions received are contingent on a future event does not affect the assessment of whether the performance obligation has been satisfied
- Transaction price at the transaction date of the initial insurance contract would include both initial commission and expected renewal commissions and would be recognized as revenue at that date, but only if it is probable that there will not be a significant reversal of the revenue for renewal commissions.
- Consideration of expected lapses during the renewal periods would be included in the estimation of the expected fee.

Polling Question #4

Do you believe the recoding of expected renewal commissioners would enhance financial reporting ?

A. Yes

B. No

C. Maybe

D. Not applicable

Disclosures and Statutory Accounting Implications

Disclosures

Disclosures:

- Disaggregation of Revenue
- Contract Balances
- Performance Obligations
- Significant Judgements

In periods prior to adoption, disclosure should be made regarding the status and expected impact of adoption.

Statutory Accounting Considerations

- Given new revenue recognition does not apply to insurance contracts
    a. Exposed to reject all GAAP literature
    b. Current revenue recognition in SSAP’s retained

Thank you

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