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GAAP Revenue Recognition for Insurance Entities and Related Organizations

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Johnson Lambert is dedicated to keeping you current on the impact of the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers* (ASC 606). This white paper presents the most significant changes related to applying ASC 606 to non-insurance contracts entered into by insurance entities and related organizations.

Background

In 2002, the FASB and International Accounting Standards Board embarked on a joint project to clarify the principles for recognizing revenue. In 2014, the FASB issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, the first of several ASUs that created and amended ASC 606. This new standard sets out a single framework for revenue recognition and supersedes virtually all previous revenue recognition guidance with the exception of certain industry specific guidance. Insurance contracts, such as property and liability, life and health, title, and mortgage guarantee contracts, are specifically scoped out of ASC 606, and continue to be accounted for under ASC 944, *Financial Services - Insurance*. However, insurance entities and related organizations may enter into other contracts that are within the scope of ASC 606. The standard is effective January 1, 2019 for nonpublic companies.

Contracts in Scope

Contracts entered into by insurance entities and related organizations that may be within the scope of ASC 606 include:

- Managing general agent services, such as underwriting and policy maintenance, accounting, and claims services
- Producer services
- Claims administration services
- Risk management services
- Administrative services only plans or arrangements

However, certain insurance contracts may include services that are considered fulfillment activities, such as insurance risk mitigation or cost containment activities. These services are not bifurcated under ASC 606, but considered part of an insurance contract within the scope of ASC 944 as they include an element of underwriting risk.

The AICPA Financial Reporting Executive Committee indicated they generally believe the following are fulfillment activities, when included in insurance contracts and are within the scope of ASC 944:

- Claims adjudication/processing - For example, a property and liability insurance company offers high deductible policies that include claims handling services below and above the deductible amount. This service increases the insurer's chance for a better claims outcome by mitigating the risk of loss above the deductible. Another example is a high deductible health insurance policy that includes fulfillment activities, such as routine physicals and screenings, immunizations, preventative care, and wellness benefits. Even when the above activities are partially provided as a service to the customer, they help the insurer mitigate risks, and the entire contract is accounted for under ASC 944.
- Safety inspections - For example, a workers compensation insurer may perform safety inspections of an insured's workplace, which could mitigate risks.
- Roadside assistance - This service may prevent further damage to an insured automobile.
- Cybersecurity provisions included in a general liability insurance contract.
- Title search provided with a title insurance policy.

Although insurance entities primarily enter into insurance contracts subject to ASC 944, they may also enter into non-insurance contracts subject to ASC 606. For example, an insurance entity might provide claims administration services on a fee basis to an unrelated insurance carrier.

New Revenue Recognition Model

The **core principle** of the new revenue recognition model is that an entity must recognize revenue that represents the transfer of promised services to customers in an amount reflective of the price the entity expects to be entitled to in exchange for those services.

To satisfy the core principle, an entity must apply, document, and conclude on the new Five Step Model.

1 Identify the Contract with the Customer

The guidance defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations."

For example, Entity A (a managing general agent) enters into a contract with Customer X (an insurance company) to provide underwriting and policy maintenance, claims, and accounting services. We will use this example (shown in blue, italicized font) throughout the white paper to illustrate the five step model. Additional examples are shown in orange, italicized font.

A contract exists if all of the following conditions are met:

1. The parties have approved the contract and are committed to perform their respective obligations. The approval may be in writing, an oral agreement or based on customary business practices.

   Entity A and Customer X have signed a written contract and are committed to perform their obligations.

2. The contract identifies the services to be provided and the parties' rights regarding such services.

   The contract specifies Entity A will provide underwriting and policy maintenance, claims, and accounting services.

3. Payment terms are established. The transaction price may be fixed or variable but is not required to be stated in the contract as long as there is an enforceable right to payment and sufficient information to enable the entity to estimate the transaction price.

   The contract is for a period of one year. Compensation for underwriting and policy maintenance, claims, and accounting services is 25% of written premium of bound policies plus an additional 4.5% profit sharing commission provided the insurer's loss ratio is below 50%. Payment is due no later than 10 days after the close of each calendar month. The profit sharing commission is settled six months after the contract term ends.

4. The contract has commercial substance, meaning the parties' future cash flows will change as a result of the contract.

   Entity A concluded the contract has commercial substance as its compensation will fluctuate based on the success or failure of its business development, underwriting, and claims handling efforts.

5. It is probable the entity will collect the consideration it is due under the contract, which is based on the customer's ability and intent to pay. If collectibility is **not probable**, the **contract is not valid** until probability is resolved. When assessing collectibility an entity should evaluate whether contractual terms or customary business practices exist that may mitigate credit risk. Examples of contractual terms may include the ability to stop providing services for non-payment and payments due at the beginning of each month.

   Under the contract, Entity A may stop providing services to Customer X for non-payment. Payment is due no later than 10 days after the close of each calendar month. Entity A concluded Customer X has the ability and intent to pay the amount of consideration when due based on the contractual terms and its collection history with Customer X.

Contract Duration (and Termination Rights)

The contract duration is the period in which the parties to the contract have present **enforceable rights and obligations.** Determining the contract's duration is key as it could affect the identification of performance obligations and transaction prices. Termination provisions may affect the contract duration. The guidance states "a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a **wholly unperformed** contract without

compensating the other party." A contract is considered **wholly unperformed** when: (1) services have not been transferred to the customer and (2) the entity has not received, and is not entitled to receive, consideration for such services.

Therefore, a one year contract containing a termination clause that allows either party to terminate the contract with a 30 day notice, without penalty, may require the entity to account for the contract as a monthly contract with a renewal option. The duration of a contract with a significant termination penalty is the period through which a termination penalty is due. In the event the termination penalty is due before the end of the stated term, the termination penalty should be included in the transaction price.

The contract between Entity A and Customer X has a fixed term of one year and cannot be canceled. Therefore the contract duration is one year.

Combining Contracts

An entity should combine and account for contracts as a single contract, provided the contracts are entered into at or near the same time with the same customer or related parties and the contracts are (1) negotiated as a package with a single commercial objective or (2) the contract prices are interrelated or (3) the services are considered a single performance obligation. This ensures entities use reasonable inputs in their revenue recognition calculations.

An entity enters into a contract with a customer for accounting services and shortly thereafter enters into a separate contract for claims services. These contracts are combined and evaluated together when allocating the price to each performance obligation.

Portfolio of Contracts

As a practical expedient, similar contracts need not be analyzed separately provided their provisions are materially consistent with one another.

2 Identify the Performance Obligations

Once the contract is identified and the contract duration is determined, the next step is to identify each performance obligation. Each distinct service (performance obligation) is accounted for separately. A distinct service is one that is clearly distinct in the contract and benefits the customer individually or in conjunction with other resources.

A performance obligation is defined as a contractual promise to transfer to the customer either:

- A service (or a bundle of services) that is distinct, or

  Underwriting and policy maintenance services include binding new and renewal business and servicing the policies (i.e., processing changes or cancellations by the policyholders) during the effective period.

- A series of distinct services that are substantially the same and have the same pattern of transfer to the customer. Such services may be recognized over a period of time and treated as a single performance obligation.

  Accounting services include bookkeeping. Such services are unlimited and provided as needed.

  Claims services include investigating, adjusting, and settling claims. Such services are unlimited and provided as needed.

  Entity A determined the accounting and claims services have the same pattern of transfer (daily) and each meets the definition of a series.

Contracts may contain services that are not distinct. In those circumstances, non-distinct services should be bundled together until the bundle of services is distinct. Factors that indicate bundling is appropriate include services that must be integrated in order to deliver the contracted service to the customer, the service significantly modifies or customizes another service, or the services are highly interdependent or interrelated.

Principal vs. Agent

When multiple entities are involved in providing contractual services to a customer, those entities must evaluate whether they are a **principal** or **agent**. This designation is determined by who controls the service and drives whether revenue is recorded on a gross or net basis.

Principal	Agent
A principal may provide the specified service itself or has the ability to direct another party to provide the service on its behalf	An agent is a party that acts for and on behalf of another party
Record revenue on a gross basis	Record revenue on a net basis

ASC 606 states, "control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset" and "includes the ability to prevent other entities from directing the use of, and obtaining the benefits from, an asset." Services are considered assets, even if only briefly, when they are received and used.

As Entity A acts on behalf of Customer X, it is an agent. As such, Entity A does not record the gross premium revenue for policies bound, but rather records as revenue the compensation it is entitled to receive under the contract.

3 Determine the Transaction Price

The transaction price is the amount an entity expects to receive in exchange for providing services. The transaction price may be fixed, variable or both, and may be affected by the following components:

- Variable consideration including variable consideration with constraints and refund liabilities

  The entity offers a premium volume incentive or profit sharing commission - constraints due to uncertain future events.

  The entity is obligated to refund all or a portion of the transaction price upon cancellation - refund liability.

- Significant financing provision - To the customer's benefit

  The customer obtains free financing or at a rate significantly below market.

  There is a significant lag between when the service is performed and payment is due.

- Significant financing provision - To the service provider's benefit

  The service provider receives payment long before the service is performed (upfront payment).

- Non-cash consideration

  The service provider obtains a certain number of shares of the customer's common stock in exchange for promised services. Non-cash transactions are measured at fair value.

- Consideration payable to a customer

  Consideration may include credits (vouchers, coupons) that reduce the transaction price.

The transaction price includes fixed consideration and estimates for variable consideration. When estimating a variable consideration, an entity is required to use either the "expected value" or "most likely amount" method, which the standard defines as follows:

- The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts.
- The most likely amount is the single most likely amount within a range of possible results.

Several factors should be considered when estimating variable consideration, such as past experience, factors outside the entity's influence and the amount of time expected to lapse before the amount is finalized. The transaction price should only include the portion of the estimated variable consideration that is **not probable** to **significantly reverse** when the final transaction price is determined. At each measurement period, an entity should reassess the estimated portion of the transaction price until settled.

An entity should also estimate the time value of money for **significant** financing benefits. This adjustment requires the entity to recognize revenue in the same amount it would have received had the customer paid cash for the service in a timely manner. The discount rate should remain the same throughout the contract duration. As a practical expedient, no adjustment is required if payment is expected within one year or less from the completion of the services.

Entity A's transaction price includes the following components:

- *Fixed price*
    - *Underwriting and policy maintenance, claims, and accounting services - 25% of premium written*
- *Variable price (refund liability)*
    - *Refund for policy cancellations*
- *Variable price with constraint*
    - *4.5% profit sharing commission provided the loss ratio is below 50%*

Entity A has significant experience as a managing general agent and its book of business has yielded loss ratios between 42% and 49% over the last five years. It expects no change to its book of business. Although potential uncertainty from external factors outside its control exist, the final profit sharing commission adjustment is made six months after the contract ends (resolved within a short period). Therefore, Entity A concludes that a significant reversal in the cumulative amount of estimated revenue is not probable.

Using the expected value method, Entity A estimates the transaction price for the profit sharing commission at 4.5% of written premium of bound policies. Entity A will reassess the transaction price for the variable consideration with constraint at each measurement period until settled.

Entity A is obligated to refund Customer X the service fee for canceled policies. As it is not entitled to the full transaction price, Entity A must record a refund liability equal to the portion of the transaction price it expects to be refunded. Using the expected value method, Entity A estimates 3% of bound policies will be canceled. This estimate is reassessed, and adjusted as needed, at each measurement period.

Assume a producer (the entity) enters into a contract with an insurance company (the customer) and the producer's compensation is based on the written premium bound (volume incentive commission) as follows:

- *10% for written premiums less than $1 million*
- *11% for written premiums of $1 to $1.5 million*
- *12% for written premiums greater than $1.5 million*

Based on past experience, the producer expects to bind $1.3 million of written premium. The producer estimates its transaction price at 11%. At the next measurement period, based on updated information, the producer now believes it expects to bind more than $1.5 million in written premiums. The producer then recognizes a catch up adjustment equal to 1% of written premium bound to date, and prospectively adjusts the transaction price to 12%.

4 Allocate the Transaction Price to the Performance Obligations

If a contract has multiple performance obligations, an entity must determine the **standalone** selling price of each performance obligation. An entity should not presume the standalone selling price is equal to a contractually stated price. An observable price of a service sold to a similar customer under similar circumstances provides the best evidence of a standalone selling price. An entity must estimate the standalone selling price when one is not readily observable, using one of the following approaches:

- Adjusted market assessment approach - Use competitors' prices for similar services adjusted to reflect the entity's costs and margins.
- Expected cost plus a margin approach - Forecast the expected cost to provide the service plus a margin to reflect what the market is willing to pay.
- Residual approach - Subtract the sum of observable standalone selling prices of other services from the total transaction price. This approach is allowed only when certain circumstances are met.
- A combination of these approaches.

Once the standalone selling price for each performance obligation is determined, the next step is to allocate certain other variable considerations, such as discounts. Generally, discounts are allocated on a prorata basis to all performance obligations in the contract. However, in certain situations where observable evidence is available, the discount may be allocated to specific performance obligations.

Entity A's services are priced as follows on a standalone basis.

Underwriting services	*15% of premium written*
Accounting services	*10% of premium written*
Claims services	*5% of premium written*
	30%

Entity A offered a discounted rate of 25% to Customer X who entered into the contract for all three services. The discount is allocated on a prorata basis as follows:

Underwriting services	*12.5% ((15% ÷ 30%) X 25%)*
Accounting services	*8.3% ((10% ÷ 30%) X 25%)*
Claims services	*4.2% ((5% ÷ 30%) X 25%)*
	25.0%

Although Entity A concluded the discount should be allocated to all performance obligations and on a prorata basis, another entity may conclude the discount should be allocated only to certain performance obligations based on observable evidence it has.

Subsequent changes to or reassessments of the transaction price are allocated in the same manner used at contract inception. However, the transaction price may not be modified due to subsequent changes to standalone selling prices.

5 Recognize Revenue when (or as) the Entity Satisfies a Performance Obligation

The final step in the model is to recognize revenue for each performance obligation based on the respective allocated price as the service is performed. Performance occurs when control is transferred to the customer, which may be at a **point in time** or **over time**. An entity recognizes revenue over time if the customer receives and consumes the benefits of the services as they are performed.

When services are **satisfied over time**, an entity must elect a **single method** by which to measure its progress toward the completion of each performance obligation. Such method should be used for the duration of the contract and applied to similar services under similar contracts. Appropriate methods for measuring progress include the input and output methods.

Under the input method, revenue is recognized based on the entity's efforts relative to the total efforts expected to satisfy the performance obligation. It may be appropriate to recognize revenue on a straight-line basis if the efforts

are dispensed evenly throughout the performance period.

Under the output method, revenue is recognized based on the value of the services transferred to the customer to date relative to the remaining services promised under the contract. Methods may include milestones reached, resources consumed or labor hours expended.

Entity A recognizes revenues as follows:

Underwriting services - Commission revenue of 12.5% of written premium is recognized upon the effective date of the underlying policy (a point in time), as Entity A believes ***no significant*** *performance obligations remain after the policy effective date. Additionally, the profit sharing commission of 4.5% of written premium represents a form of variable consideration associated with the placement of coverage for which additional commissions can be earned. The profit sharing commission is estimated with a constraint applied and accrued relative to the recognition of the core commissions.*

Accounting services - Accounting services revenue of 8.3% of written premium is recognized as revenue over time on a straight-line basis as Entity A believes the services are available on an unlimited and as needed basis over the term of the bound policies.

Claims services - Claims services revenue of 4.2% of written premium is recognized over time as the performance obligation is satisfied based on estimated labor hours expended as Entity A believes it is obligated to adjust claims until closure.

Policy cancellations - A refund liability of 3% of written premium is recognized. The liability is relieved only when cash is refunded or the refund privilege expires.

The measure of progress should be updated to reflect changes in the outcome of the performance obligation at each measurement period and recorded as a change in accounting estimate.

Other Considerations

Contract Liability

A contract liability (deferred revenue) is recognized when payment is received or due from the customer before services are transfered.

Cash (or Accounts Receivable)	XX	
Contract liability		XX

No later than ten days after the close of each calendar month, Entity A receives payment from Customer X for claims services. Entity A recognizes the cash received as a contract liability and earns the revenue as estimated labor hours are expended and services are transferred.

Receivable Versus Contract Asset

An entity records a receivable when services are transferred and the right to the consideration is unconditional.

Entity A shall receive payment from Customer X no later than ten days after the close of each calendar month (unconditional and due to passage of time).

An entity records a contract asset when services are transferred and the right to the consideration is conditional.

Entity A records a contract asset for the profit sharing commission receivable as payment consideration is contingent upon a loss ratio of less than 50% (conditional), and cannot be billed and collected until such condition is met.

Incremental Costs of Obtaining a Contract

Incremental costs are those the entity would not incur without the execution of the contract, such as sales commissions and bonuses paid to employees as a

percentage of each sale. Such costs are recognized as an asset if an entity expects to recover them. The asset is amortized consistent with the transfer of services to the customer to which the asset relates. The guidance provides a practical expedient to expense such costs when incurred if the amortization period is one year or less.

Contract Modifications

Contracts may be amended to modify the scope and/or price. An entity must determine if the amendments should be accounted for as a separate contract.

Separate Contract

A contract modification is treated as a separate contract when the amendments meet two criteria: (1) distinct services are added and (2) the increase in contract price **reflects the standalone selling price** of the additional distinct services. An entity may reduce the selling price and still meet the second criteria for the acquisition costs not expected to be incurred.

Assume the original contract between an entity and customer included underwriting services only. The contract is later amended to add claims services and the additional consideration is based on the standalone selling price. Under these circumstances, the underwriting services continue to be accounted for under the original contract and the claims services are treated as a new standalone contract for the purpose of revenue recognition.

Assume the original contract between an entity and customer is for one year. The contract is later amended to add one additional year of service, and the additional consideration is based on the standalone selling price. The additional year of services is treated as a new standalone contract.

Not a Separate Contract

Contract modifications that do not meet the criteria to be treated as a separate contract fall under the following categories:

1. Termination of the existing contract and creation of a new contract
2. Modification to the original contract
3. A combination of (1) and (2)

Termination of the Existing Contract and Creation of a New Contract

When the services to be transferred after the contract modification date are distinct from the services transferred on or before the contract modification date, and the additional consideration is not reflective of the standalone selling price of such services, the existing contract is considered terminated and replaced with a new contract. The amount of consideration allocated to the new contract is the amount of revenue not yet recognized under the original contract plus the additional consideration promised under the contract modification.

An entity is originally contracted to provide underwriting services for one year for $120,000 (or $10,000 per month). After six months, the parties agree to amend the contract to add 12 months of service (a total of 24 months) for an additional $80,000. The entity concluded the additional consideration is not representative of the standalone selling price. As such, the original contract is terminated and a new contract is created. The transaction price under the new contract is $140,000, which consists of the remaining consideration under the original contract of $60,000 plus the additional consideration under the contract modification of $80,000. The transaction price is allocated to the remaining eighteen months of the contract.

Modification to the Original Contract

When the services to be transferred after the contract modification date are not distinct from the services transferred on or before the contract modification date, the existing contract is modified, and the change in transaction price is recognized in revenue on a cumulative catch-up basis.

A producer enters into a contract with a managing general agent and is eligible for a 6% profit sharing commission provided the loss ratio is below 50%. Based on experience (observable data), the producer concludes the profit sharing (variable consideration with constraint) should not be recognized as revenue. After one month, the contract is modified to add a new region. The new region is very familiar to the two new sales agents that joined the producer, and their experience (observable data) shows a very low loss ratio for the new region. The producer concludes that with the combination of the new and old regions, it is probable they will receive the 6% profit sharing commission. The producer records a catch-up adjustment of 6% of written premium for the policies bound during the first month and recognizes the 6% commission going forward.

Warranty Contracts

Warranty contracts issued by insurance entities continue to be accounted for under ASC 944.

Warranty contracts issued by non-insurance entities are accounted for and disclosed under ASC 606 or ASC 460, *Guarantees*.

Service-type warranty contracts are accounted for under ASC 606 as the warranty provides additional and distinct services. Revenue is recognized over the period and pattern in which the performance obligation is satisfied.

Assurance-type warranty contracts are accounted for under ASC 460 as the warranty effectively provides a guarantee that goods or services sold to the customer meet certain specifications.

Disclosures

The guidance requires a nonpublic entity to disclose:

- Revenue recognized from contracts with customers, disclosed separately from other sources of revenue, on the face of the financial statements or in the notes to the financial statements
- Impairment losses on receivables or contract assets from contracts with customers, disclosed separately from other impairment losses
- Revenue recognized from contracts with customers, disaggregated according to the timing of transfer of services (e.g., at a point in time, over time)
- Qualitative information concerning how economic factors affect the nature, timing, and uncertainty of revenues and cash flows
- Opening and closing balances of receivables, contract assets, and contract liabilities, on the face of the financial statements or in the notes to the financial statements
- Revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (e.g., changes in estimated profit sharing commissions)
- Description of its performance obligations:
    - Nature of services it promised to transfer (principal) or arrange (agent)
    - When performance obligations are satisfied (e.g., at a point in time, over time)
    - Significant payment terms
    - Obligations for refunds or other similar obligations
    - Types of warranties and related obligations

- Significant judgments and subsequent changes, made when determining the timing of satisfaction of performance obligations, the transaction price, and amounts allocated to performance obligations, including:
    - Methods used to recognize revenue for contracts satisfied over time (i.e. output or input method)
    - Methods, inputs, and assumptions used to assess whether an estimate of variable consideration is constrained

Transition

ASC 606 may be adopted using a full or modified retrospective approach. Entities that elect to use practical expedients must disclose that fact and the qualitative assessment of the effect, if practical. Nonpublic entities are required to make the following disclosures in the year of adoption.

Full Retrospective Approach

- Adoption of the standard
- Prior year financial statements have been retrospectively adjusted (restated)
- Cumulative effect on retained earnings
- The effect of the change on impacted financial statement line items. Disclosure of the effect on financial statement totals and subtotals, other than income from continuing operations and net income, is not required. Disclosure of the effect of the changes on the current period is not required.
- Practical Expedients
    - Contracts that begin and end in the same period are not required to be restated
    - Completed contracts with variable consideration may use the final transaction price
    - For periods presented prior to the date of adoption, an entity may elect to not disclose when it expects to recognize in revenue the transaction price allocated to remaining performance obligations.
    - For contracts modified prior to the beginning of the earliest period presented, an entity may reflect the aggregate effect of such modifications that occurred prior to the beginning of the earliest period when:
        - Identifying the satisfied and unsatisfied performance obligations
        - Determining the transaction price
        - Allocating the transaction price to the satisfied and unsatisfied performance obligations.

Modified Retrospective Approach

- Adoption of the standard
- Recognize a cumulative effect adjustment to the opening balance of retained earnings
- Whether the standard was applied to all contracts or to contracts not completed as of the date of adoption
- The effect of the change on impacted financial statement line items in the current reporting period and an explanation of significant changes

- Practical expedient:
  - For contracts modified prior to the beginning of the earliest period presented, an entity may reflect the aggregate effect of such modifications that occurred prior to the beginning of the earliest period presented when:
    - Identifying the satisfied and unsatisfied performance obligations
    - Determining the transaction price
    - Allocating the transaction price to the satisfied and unsatisfied performance obligations.

The content contained herein should not be relied upon as accounting or tax advice as it does not take into account any specific organization's facts and circumstances.

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