



INSIGHTS FROM THE BDO INSURANCE PRACTICE

ASC 606 REVENUE RECOGNITION GUIDANCE FOR THE INSURANCE INDUSTRY

Addressing Common Implementation Issues for Insurance Entities, Brokers, Agencies, Third Party Administrators and the Warranty Industry

The new revenue recognition standard, ASC 606-Revenue from Contracts with Customers, issued by the Financial Accounting Standards Board (FASB or Board) became effective for public entities for fiscal years beginning after December 15, 2017, and for interim periods therein. Nonpublic entities were required to adopt the standard for fiscal years beginning after December 15, 2018, and during interim periods within fiscal years beginning after December 15, 2019.

This new standard supersedes most previously issued U.S. Generally Accepted Accounting Principles (GAAP) guidance for revenue recognition—and impacts all entities that enter into a contract with a customer to provide goods or services, with the exception of customer contracts that are within the scope of other GAAP guidance.

As clarified in Accounting Standards Update (“ASU”) 2016-20, all contracts within the scope of FASB ASC 944, such as investment contracts, life and health insurance, property and liability insurance, title insurance and mortgage guarantee insurance, are excluded from the scope of FASB ASC 606. However, contracts insurance companies enter into that are not within the scope of ASC 944 are to be accounted for under ASC 606.

This publication addresses the most commonly encountered issues when applying the guidance in ASC 606 for insurance entities, brokers, agencies, third-party administrators and the warranty industry.

ASC 606 CORE PRINCIPLES

The core principle of the guidance in ASC 606 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps:

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

SCOPE OF ASC 606

Insurance-related services

Though insurance contracts within the scope of ASC 944 are excluded from ASC 606, as noted above, insurance entities may offer a single or combined product(s) or service(s) that could result in a customer contract being within the scope of both ASC 606 and ASC 944.

In accordance with paragraph BC15 of ASU No. 2016-20, for contracts that are within the scope of ASC 944, the insurance entity should determine if elements of the contract should be accounted for within ASC 944 or ASC 606. If it is determined that a contract is not entirely within the scope of ASC 944 due to elements of the contract being within the scope of ASC 606, the insurance entity should apply the guidance in ASC 606-10-15-4 in order to determine how to separate the contract into the constituent parts.

Also, as explained in paragraph BC15 of ASU 2016-20, there could be activities included in the contract, such as insurance risk mitigation or cost containment activities, that should be considered fulfillment activities, not within the scope of ASC 606, but which should be considered part of the contract within the scope of ASC 944, consistent with current practice.

The following are examples of activities performed by an insurance entity, included in contracts within the scope of ASC 944, that FinREC¹ believes generally should be considered fulfillment activities (that either mitigate risks to the insurer or contain costs related to services to fulfill the insurer's obligation) that are not

within the scope of ASC 606, but should be considered part of the contract within the scope of ASC 944:

Claims adjudication and processing

These activities can be included with commercial property casualty insurance contracts (e.g., general liability, property, automobile and workers' compensation) offered as a high deductible policy, such that the policyholder is "self-insuring" numerous claims below the deductible, that specifies that the adjudication/processing of claims both above and below the deductible amount will be performed by the insurer.

These claims adjudication and processing activities are performed even if the high deductible is ultimately not reached. Compensation for claims adjudication and processing below and above the deductible is either: 1) an explicit or implicit component of the policy premium; or 2) separately billed to the policyholder based on a percentage of paid or incurred losses, or as a flat charge per claim and referred to as a claims servicing charge.

For those claim activities below the deductible, although the activities are partially provided as a service to the customer, they also mitigate the insurer's risk of loss above the deductible. Generally, from the insurer's perspective, a holistic view is taken in managing claims from the ground up (from below the deductible through the insurer's limit), whether the insurer performs the claims adjudication or if it is outsourced to a third party. The insurer is integral in developing the strategy and approach for settling a claim below or above the deductible, along with the insured or the third-party administrator if one is involved (that is, whether a loss event is ultimately covered within the insurance protection provided or not).

Health insurance contracts within the scope of ASC 944 (e.g., medical including high deductible health plans [HDHPs], dental, vision)

Additional activities related to the fulfillment of the insurance contract may include enrollment (for group plans), provider network access, routine physicals and screenings, immunizations, preventative care and wellness benefits, transportation to facilities for treatment, and access to durable medical equipment (e.g., wheelchairs and crutches), and wellness benefits that include biometric screening, tobacco cessation, personal health assessments and records, health coaching and disease management provided with health insurance contracts within the scope of ASC 944.

Consistent with the claim activities related to commercial property casualty insurance discussed above, these types of activities typically mitigate the insurer's risk of loss by

¹ The Financial Reporting Executive Committee ("FinREC") is the designated senior committee of the American Institute of Certified Public Accountants ("AICPA"), authorized to speak for the AICPA in the areas of financial accounting and reporting. See additional discussion in chapter 14 of the Revenue Recognition Audit and Accounting Guide (AAG).

providing a holistic approach to preventing or limiting initial or additional claims.

Safety inspections

These activities are sometimes provided with a property and liability insurance contract and such activities can also be viewed as mitigating the insurer's risk.

Roadside assistance provided with an automobile insurance policy

Examples of activities provided are towing cars from an accident location or changing a flat tire, which both help mitigate the risk of a further accident or damage to the car.

Cybersecurity activities

These activities are sometimes provided with a general liability insurance contract and such activities can be viewed as mitigating the insurer's risk.

A title search provided with a title insurance policy

This activity is part of fulfilling the insurance contract and mitigating the insurer's risk.

Conversely, in some situations claims adjudication and processing activities may not be part of the fulfillment activities of an insurance contract. For example, structures may be offered in the marketplace in which a commercial customer will purchase a high-deductible property casualty insurance contract. Under this policy, insurance coverage may be provided only for claims above a specified deductible amount, and the customer may obtain claims adjudication and processing services from a third-party administrator (oftentimes a subsidiary of another insurance group) unrelated to the insurer providing the insurance coverage. That third party would be subject to ASC 606 for its provision of claims processing services. In these cases, the claims adjudication and processing services are not offered in conjunction with an insurance contract. As explained in paragraph BC14 of ASU 2016-20, contracts offered by an insurance entity that are not within the scope of ASC 944, such as administrative services only contracts without any insurance element, should be accounted for under ASC 606.

Combination of contracts

An insurance entity, such as a health insurer, may enter into an administrative services-only contract and an insurance contract at the same time with the same party. If either contract's price was discounted from the insurance entity's normal pricing practices, this may suggest a pricing interdependency under which these contracts may need to be treated as one arrangement. That is, although the combination of contracts guidance in

ASC 606-10-25-9 is not applicable to contracts outside the scope of ASC 606 (e.g., a contract in the scope of ASC 944), FinREC² believes that insurance entities should consider the economics and nature of the arrangements (including pricing interdependencies), when assessing whether contracts with the same customer (or related parties of the customer) should be combined for accounting purposes.

If an insurer determines that the contracts should be combined for accounting purposes, FinREC believes that the entity should look to paragraph BC15 of ASU 2016-20, to determine whether the activities in the combined contract, other than providing insurance coverage, are predominantly performed as part of fulfilling the insurance obligation or mitigating the insurer's insurance risk.

If an insurer determines that the activities are predominantly performed as part of fulfilling the insurance obligation or mitigating the insurer's insurance risk, FinREC believes that the combined contracts should be accounted for as one contract under ASC 944.

If an insurer determines that the activities of the combined contract are not predominantly performed as part of fulfilling the insurance obligation or mitigating the insurer's insurance risk, FinREC believes that the guidance in ASC 606 should be applied to determine the allocation of the combined consideration between: a) those noninsurance performance obligations to be accounted for under ASC 606; and b) insurance coverage (assuming that it meets the criteria to be classified as an insurance contract under ASC 944) to be accounted for under ASC 944.

TIMING OF REVENUE FOR BROKERS, AGENCIES AND THIRD-PARTY ADMINISTRATORS

The timing of revenue recognition for brokers and agencies will be materially impacted as these entities previously recognized revenue when received (contingent commissions) or at the later of the billing date or policy effective date.

Under ASC 606, the policy effective date will now be the predominant date used for the recognition of revenue related to brokerage services based on the premise that the revenue has been earned in the placement of the policy. It will be critical for the broker or agency to identify all promises made in the contract, as revenues allocated to other performance obligations may be recognized at different times. The following are examples of typical revenue types or cash flow streams. However, it is essential the entity look to the performance obligations and not the revenue type or cash flow streams in determining the timing of revenue recognition.

² See paragraphs 14.7.12 through 14.7.15 in the Revenue Recognition AAG.

Brokers

Commissions and fees

The primary source of revenues for brokerage services is commissions from underwriting companies, based on a percentage of premiums paid, or fees received from clients based on an agreed level of service usually in lieu of commissions. Under ASC 606, the portion of these commissions and fee revenues that is allocated to the brokerage service is substantially recognized at a point in time on the effective date of the associated policies when control of the policy transfers to the client. However, any revenues allocated to other performance obligations such as ongoing administrative support should be deferred to reflect delivery of services over the contract period.

Commissions rates are fixed at the contract effective date and are generally based on premiums for insurance coverage or employee head count for employer sponsored benefit plans. Commissions depend upon a large number of factors, including the type of risk being placed, the particular underwriting enterprises demand, the expected loss experience of the particular risk of coverage, and historical benchmarks surrounding the level of effort necessary to place and service the insurance contract. Rather than being tied to the amount of premiums, fees are most often based on an expected level of effort to provide their services.

Whether a company is paid a commission or a fee for services associated with the placement of an insurance (or insurance-like) contract, the commission or fees are typically recognized on the effective date of the underlying insurance contract. To determine how much consideration to allocate to the placement services, an entity should determine the standalone selling price of the placement services and of each additional performance obligation identified. One basis for determining standalone selling price is to calculate the costs to provide the services, plus an appropriate estimate of profit margin on a portfolio basis (a practical expedient allowed in ASC 606). The revenue earned under the contract, including an estimate of residual commissions, is then allocated between the placement services and the other performance obligations, if any, on a relative standalone selling price basis. Any amounts allocated to other services provided should be recognized over the period that the customer benefits from those services. Note that the benefit period can be different than the underlying premium payment pattern of the insurance contracts.

For certain consulting and advisory services, companies may recognize revenue in the period in which they provide the service or advice rather than over time. Insurance entities should consider the guidance in paragraph 606-10-25-23 through 25-30 when determining whether revenue should be recognized over time or at a point in time. For management and administrative services, revenue is typically recognized ratably over the contract period consistent with the performance of obligations, most often over an annual term.

Contingent revenues

Brokerages also receive additional revenues for risk selection knowledge, or administrative efficiencies. These amounts are in excess of the commission or fee revenues, and not all business with participating underwriting enterprises is eligible for contingent revenues. These revenues vary, generally based on growth, the loss experience of the underlying insurance contracts, and/or efficiency in processing the business. The companies typically do not receive these revenues from the underwriting enterprises until the following calendar year, generally in the first and second quarters, after verification of the performance indicators outlined in the contracts.

Accordingly, during each reporting period, the companies must make a best estimate of amounts earned using historical averages and other factors to project such revenues. These estimates are generally determined each period on a contract-by-contract basis where available. In certain cases, it is impractical to assess a very large number of smaller contingent revenue contracts, so companies can utilize a historical portfolio estimate in aggregate (a practical expedient as defined in ASC 606).

The ultimate contingent revenue amounts to be earned can vary from period to period especially in contracts sensitive to loss ratios and estimates might change significantly from quarter to quarter. For example, in circumstances where revenues are dependent on a full calendar year loss ratio, adverse loss experience in the fourth quarter could not only negate revenue earnings in the fourth quarter, but also trigger the need to reverse revenues previously recognized during the prior quarters. Variable consideration is recognized when companies conclude, based on all the facts and information available at the reporting date, that it is probable that a significant revenue reversal will not occur in future periods, called the constraint rule.

Administration only contracts

Administration only contracts may provide for fees to be established on a per-claim basis, under which the obligation is to process claims for a term specified within the contract. Because it is impractical to recognize revenues on an individual claim-by-claim basis, companies typically recognize revenue plus an appropriate estimate of profit margin on a portfolio basis by grouping claims with similar characteristics (a practical expedient as defined in ASC 606). The companies apply actuarially-determined, historical-based patterns to determine future service obligations, without applying a present value discount.

Cost-plus fees

Where companies provide services and generate revenues on a cost-plus basis, they recognize revenue consistent with the completion of each performance obligation.

Performance-based fees

Certain companies receive additional fee revenues for efficiency in managing claims or on the basis of claim outcome effectiveness. These amounts are in excess of the fee revenues discussed above. These revenues vary, generally based on performance metrics set forth in the underlying contracts. These arrangements generally operate under multi-year contracts with fiscal year measurement periods. Companies do not receive these fees, if earned, until the following year after verification of the performance metrics outlined in the contracts. To recognize revenue each period, the companies must make a best estimate of amounts earned using historical averages and other factors to project such revenues, subject to the constraint.

WARRANTY CONTRACTS

In accordance with ASC 606-10-15-2, an insurance entity should continue to apply the guidance in ASC 944 to warranty contracts that are within the scope of ASC 944 because they are written by an insurance entity³. However, extended warranty contracts not written by an insurance entity, that meet the criteria in ASC 606-10-55-31, should be accounted for under ASC 606.

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."

The focus of this section is on extended warranty contracts that provide services for unscheduled repairs or replacement of the item under the contract for an unknown quantity of services for a fixed fee. It does not cover situations in which other services, such as scheduled product maintenance, are also provided. This section does not cover extended warranty contracts that only provide for the indemnification of, or reimbursement to, the customer for unscheduled repairs or replacement of the item (that is, contracts in which the company is not obligated to perform a service or engage others to perform a service, but merely to reimburse the customer).

At its January 26, 2015 meeting, the Transition Resource Group (TRG) discussed stand-ready performance obligations. Paragraph 11 of TRG Agenda Ref. No. 16, *Stand-Ready Performance Obligations*, provided examples that illustrate the benefit a customer obtains from the entity "standing ready." One example includes, "a customer that purchases an extended product warranty for a piece of equipment that requires the entity to remediate any issues with the product when-and-if problems arise."

As noted in paragraph 1.68 of the Revenue Recognition AAG, FinREC believes that the performance obligation of standing ready to provide protection against damage to, loss, or malfunction of, the warranted item caused by various perils for the specified coverage period, or to fix, arrange to fix, or replace the covered product under an extended warranty contract, which is sold separately from the product covered and provides services for unscheduled repairs or replacement of the item under the contract for an unknown quantity of services for a fixed fee, meets the criteria in ASC 606-10-25-27a. The entity would therefore satisfy the performance obligation and recognize revenue over time instead of at a point in time.

In accordance with the views expressed by the TRG at the January 2015 meeting, FinREC believes that judgment should be exercised in determining the appropriate method to measure progress toward satisfaction of a stand-ready obligation under an extended warranty contract that is sold separately from the product covered and that provides an unknown quantity of services for a fixed fee. The nature of the stand-ready obligation to provide protection against damage to, loss, or malfunction of, the warranted item caused by various perils for the specified coverage period or to fix, arrange to fix, or replace the covered product should be considered to align the measurement of progress toward complete satisfaction of the performance obligation with the nature of the entity's promise.

Impairment analysis

In accordance with ASC 605-20-25-6, a loss shall be recognized on extended warranty or product maintenance contracts, if the sum of the expected costs of providing services under the contracts and any asset recognized for incremental costs of obtaining a contract exceeds the related unearned revenue (contract liability).

OTHER TOPICS

Contract costs

As stated in ASC 340-40-25-1, "an entity should recognize as an asset the incremental costs of obtaining a contract with a customer if the entity expects to recover those costs." ASC 340-40-25-2 explains that the incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, a sales commission). ASC 340-40-25-3 further explains that costs to obtain a contract that would have been incurred regardless of whether the contract was obtained should be recognized as an expense when incurred,

³ The guidance in ASC 605-20, which included a reference to similarities between the short duration contracts model under ASC 944, has been superseded by ASC 606. Paragraphs 1 and 6 of ASC 605-20-25, which provide guidance on loss provisions for separately priced warranty and contract maintenance contracts, have not been superseded by ASC 606 and thus should continue to be applied.

unless those costs are explicitly chargeable to the customer regardless of whether the contract is obtained.

ASC 340-40-25-4 allows for a practical expedient, stating that an entity may recognize the incremental costs of obtaining a contract as an expense when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

ASC 340-40-25-5 requires an entity to recognize an asset from the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

- ▶ The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify (e.g., costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved).
- ▶ The costs generate or enhance resources of the entity that will be used in satisfying, or in continuing to satisfy, performance obligations in the future.
- ▶ The costs are expected to be recovered.

Brokers and agencies incur costs to provide brokerage and risk management services. Those costs are either: i) costs to obtain a contract; ii) costs to fulfill such contract; or iii) all other costs.

Costs to obtain – companies incur costs to obtain a contract with a client. Those costs would not have been incurred if the contract had not been obtained. Almost all of costs to obtain are incurred prior to, or on, the effective date of the contract and may consist of incentive compensation paid to production employees. The assets recognized for the costs to obtain and/or fulfill a contract are amortized on a systematic basis that is consistent with the transfer of the services to which the asset relates. For contracts where the renewal period is one year or less and renewal costs are commensurate with the initial contract, the companies may apply a practical expedient and recognize the costs of obtaining a contract as an expense when incurred.

Costs to fulfill – costs to fulfill a contract (or an anticipated contract) with a client are typically incurred prior to the effective date of the contract and relate to fulfilling primary placement obligations to clients. These costs to fulfill prior to the effective date are capitalized and amortized on the effective date. These fulfillment activities may include collecting underwriting information from our client and negotiating the placement of policies with end customers. Most costs that are incurred relate to compensation and benefits of client service employees. Costs incurred during preplacement activities are expected to be recovered in the future. The assets recognized for the costs to fulfill a contract are amortized on a systematic basis that is

consistent with the transfer of the services to which the asset relates. If the capitalized costs are no longer deemed to be recoverable, then they would be expensed.

Other costs – costs that are not costs to obtain or fulfill are expensed as incurred. Examples include other operating costs such as rent, utilities, management costs, overhead costs, legal and other professional fees, technology costs, insurance related costs, communication and advertising, and travel and entertainment. Depreciation, amortization and change in estimated acquisition earnout payable are expensed as incurred.

Contract asset or liability

Historically, when revenue was recognized but not yet billed, the entity recorded an asset for “unbilled accounts receivable.” When the billing was completed, the balance was then reclassified from unbilled to accounts receivable. ASC 606 creates a new concept called a contract asset, which generally replaces unbilled accounts receivable. A contract asset is recognized when control of a performance obligation is transferred to the customer before the customer pays consideration or before payment is due. A receivable is an entity’s right to consideration that is unconditional.

Paragraphs 1–5 of ASC 606-10-45 provide guidance for determining presentation of the contract with a customer in the statement of financial position as a contract asset, a receivable or a contract liability.

Disclosures

There are significant disclosure requirements in ASC 606. ASC 606-10-50-1 explains that the objective of the disclosure requirements is to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective an entity should disclose qualitative and quantitative information about the following:

- ▶ **Contracts with customers** — including revenue recognized, disaggregation of revenue and information about contract balances and performance obligations (including the transaction price allocated to the remaining performance obligations).
- ▶ **Significant judgments and changes in judgments affecting the amount of revenue and assets recognized** — determining the timing of satisfaction of performance obligations (over time or at a point in time) and determining the transaction price and amounts allocated to performance obligations.

Paragraphs 1–23 of ASC 606-10-50 and paragraphs 1–6 of ASC 340-40-50 provide guidance on required disclosures and practical expedients. Paragraphs 89–91 of ASC 606-10-55 provide considerations for disclosure of disaggregated revenue.

In conclusion, given the staggered deadlines for public and nonpublic entities to implement ASC 606, as well as the FASB directed delay for the former, how companies have interpreted

the new guidance has really only become clear for the first time this year. Given the myriad of insurance sub-sectors and revenue streams, it behooves the industry as a whole to take a methodical approach to interpreting ASC 606, paying special attention to the scenarios detailed in this publication.

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