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Technical Line

FASB — final guidance

The new revenue recognition standard — insurance

Insurance entities and brokers will have to apply the new revenue recognition standard to non-insurance arrangements.

What you need to know

- The new revenue recognition standard is more principles-based than current revenue guidance and will require insurance entities and brokers to exercise more judgment.
- Insurance entities will have to use the new model to account for third-party administrator arrangements and managed care arrangements. Insurance brokers also will have to apply the new standard.
- Estimating variable consideration will be a significant change for insurance entities and brokers, and they may need to change their processes and information systems to capture information they will need to apply the standard and make required disclosures.
- The new standard is effective for public entities for fiscal years beginning after 15 December 2016, including interim periods within those years, and for nonpublic entities in years beginning after 15 December 2017.

Overview

Insurance entities and brokers may need to change certain revenue recognition practices as a result of the new revenue recognition standard jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards). The new revenue recognition standard will supersede virtually all revenue recognition guidance in US GAAP and IFRS but not guidance for insurance contracts.

The new standard provides accounting guidance for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP requirements, such

as the insurance literature). The guidance also provides a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate.

Our Technical Line, *A closer look at the new revenue recognition standard* (SCORE No. BB2771), provides an in-depth discussion of the new revenue standard. This publication summarizes certain implications for insurance entities and brokers that use US GAAP.

Insurance entities and brokers also may want to monitor the discussions of both the Boards' Joint Transition Resource Group for Revenue Recognition (TRG) and a task force formed by the American Institute of Certified Public Accountants (AICPA) to focus on issues related to services provided by insurance entities and brokers. The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG won't make formal recommendations to the Boards or issue guidance. The AICPA's insurance industry task force is one of 16 industry task forces the AICPA has formed to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Any views discussed by the TRG or guidance produced by the AICPA is non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process. As our understanding of the standard evolves, we will update our guidance.

Key considerations

Insurance contracts are not within the scope of the new standard, and insurance entities will continue to apply the guidance in Accounting Standards Codification (ASC) 944, *Financial Services-Insurance*, to these contracts. However, insurance entities and brokers will have to apply the new revenue recognition standard to non-insurance arrangements, including insurance brokerage transactions, third-party administrator (TPA) arrangements and managed care arrangements.

Identifying performance obligations

For non-insurance contracts in the scope of the new standard, insurance entities and brokers may identify performance obligations (i.e., units of accounting) that they previously have not identified. The new standard requires an entity to identify all goods and services promised to a customer by reviewing the contract terms and its customary business practices. This may result in an entity identifying several separate, distinct services when it enters into a contract with a customer to perform a variety of activities (e.g., a TPA arrangement that includes insurance claims processing and administration services, integrated disability management programs, information risk management services, risk/loss control consulting services, property appraisal services). An entity would then evaluate whether the separate services should be accounted for as a single performance obligation or multiple performance obligations.

Under the new standard, a series of distinct goods or services that is transferred consecutively is treated as a single performance obligation if the goods or services are substantially the same and would be recognized over time using the same measure of progress. Certain services provided by TPAs and managed care entities (e.g., claims processing, administration services) are provided continuously over the contract period, so the services in the contract may generally represent a single performance obligation comprising a series of distinct services with a number of distinct service periods (e.g., months, quarters).

Insurance brokers frequently provide ongoing services such as processing coverage changes after the placement of insurance coverage because the customer has a valid expectation that the insurance broker will provide these services to retain its business. While an insurance

broker might consider these ongoing services to be incidental, the Boards concluded that even incidental services are services for which the customer pays (i.e., identify as performance obligations) for purposes of revenue recognition.

Estimating variable consideration

The consideration received in an insurance brokerage, TPA or managed care contract may vary in amount and timing as a result of pricing (e.g., per-member, per-claim), discounts, clawbacks, incentives or performance bonuses. The new standard requires an entity to estimate variable consideration and include in the transaction price amounts for which it is probable that a significant revenue reversal will not occur when the uncertainties related to the variability are resolved (i.e., they will have to apply a constraint on variable consideration). Possible reductions in the transaction price (e.g., for clawbacks related to refunds of an insurance broker's commission for a policyholder's early termination) will need to be carefully assessed when applying the constraint.

Under today's guidance, an entity generally cannot recognize consideration that is contingent on a future event (e.g., enrolling future members) until the uncertainty related to that event is resolved, unless the entity can demonstrate that the fee is determinable. Under the new standard, insurance entities and brokers will have to include in the transaction price the portion of contingent amounts for which they determine that it is probable that a significant reversal will not occur when the uncertainty is resolved. This means that they may determine it is appropriate to recognize some portion of these amounts before the contingencies are resolved.

Insurance entities and brokers may recognize contingent amounts before they are resolved.

For example, a managed care entity may have an annual contract with fees calculated based on monthly enrollment. Today, the managed care entity generally recognizes the monthly fee as billed because the consideration for future months is not fixed or determinable. Under the new standard, the managed care entity will have to determine whether some amount of consideration (after estimating annual enrollment and considering the constraint) should be included in the transaction price, which may result in earlier revenue recognition than under today's guidance. The standard provides a practical expedient that allows an entity to recognize revenue in the amount to which the entity has a right to invoice if the entity satisfies the performance obligation over time and the consideration received corresponds directly with the value to the customer of the performance completed to date. Managed care entities will need to assess whether they meet the conditions to apply this practical expedient.

How we see it

Applying this guidance will require significant judgment. Entities may also have to change their processes and information systems to estimate variable consideration and apply the constraint.

Allocating the transaction price

Insurance entities and brokers generally will have to allocate the transaction price to each performance obligation on a relative standalone selling price basis. Entities may find this assessment challenging for services that are not sold separately (e.g., services that today are considered incidental). In a managed care contract, a customer can select from a broad array of services that are combined and priced to achieve an aggregated profit margin and to leverage cost synergies across similar contracts. As a result, there may be multiple price points for each service, which insurance entities and brokers will have to consider in estimating the standalone selling price.

How we see it

Insurance entities and brokers likely will need to involve personnel beyond those in the accounting or finance departments, such as those involved in an entity's pricing decisions, to assist in estimating the standalone selling price of such goods or services, especially when there are limited or no observable inputs.

Variable fees for certain claims processing and administration services in multi-period contracts may be allocated entirely to distinct service periods that have already occurred (e.g., prior months) once they are no longer subject to a significant revenue reversal, if certain criteria are met.

Recognizing revenue

Under the standard, an entity will recognize revenue when it transfers control of the promised good or service to the customer. This could be either at a point in time or over time. Many of the services that insurance entities provide in non-insurance contracts are generally satisfied over time because the customer simultaneously receives and consumes the benefits provided by the insurance entity as it performs the service. While this could result in a pattern of revenue recognition that is similar to today's pattern, revenue may be recognized earlier if some or all of the consideration can be included in the transaction price, after considering the constraint.

Today, insurance brokers recognize commissions they earn at a point in time. If an insurance broker identifies other performance obligations (e.g., for ongoing services that today are considered incidental), the insurance broker may have to allocate a portion of the commission to those ongoing services and recognize revenue when those services are provided. As a result, less revenue may be recognized when the commission is earned (i.e., when the insurance broker places a new contract).

Next steps

- Entities should perform a preliminary assessment on how they will be affected as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard, even if their accounting results won't change significantly or at all.
- Entities also may want to monitor the discussions of the Boards, the Securities and Exchange Commission (SEC) staff, the TRG and the insurance industry task force formed by the AICPA to discuss interpretations and application of the new standard to common transactions.
- Public entities also should consider how they will communicate the changes with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SEC Staff Accounting Bulletin (SAB) Topic 11.M. The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available, and the entity should disclose its transition method once it selects it.

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