CFO Working Group

Revenue Recognition Sub-Group

November 7, 2018

Speakers/Presenters:
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Dan Sebastiani – CFO, Heffernan Insurance Brokers
Brian Friend – CFO, MJ Insurance

The CFO Working Group Revenue Recognition Sub Group met by telephone conference call on November 7, 2018. Council CFO, Ce Harrison, led the call with 30 attendees. The major topics covered were midterm elections aftermath, Revenue Recognition - ASC 606, Tackling Revenue Recognition, Impact on Agencies, Revenue Streams, ASC 340 – Cost Streams and Taxation Concerns.

Joel Kopperud: Midterm Elections Aftermath

- 100 new Members of Congress
- What impacts us?
    - Must pass legislation Terrorism Risk Insurance Act (TRIA) in 2020
    - National Flood Insurance Program (NFIP) expiring in December 2018 – needs to be reauthorized.
      Note: On December 21, 2018, the President signed legislation passed by Congress that extends the NFIP to May 31, 2019.

Dan Sebastiani: ASC 606 Core Principle - The Five Steps

- An entity recognizes 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.
    - **Step 1**: **Identify contract**
        - Do you have consistency in your branch or lack of consistency?
        - How many types of contracts and volume of contracts?
    - **Step 2**: **Identify performance obligations**
        - What are the core components of the contract?
        - Decide which components qualify as performance obligation
            - Distinct vs. bundled performance obligations
            - Dan’s preference: bundled performance obligations, but depends on service being provided
    - **Step 3**: **Determine transaction price**
        - Potential rebates, cancellation rates on policy, lapse in coverage – Observe historical activity and incorporate factors into the transaction price
        - Identify how much of revenue is at risk of loss over recognition period
    - **Step 4**: **Allocate transaction price**
        - Transaction price needs to be allocated to each identified performance obligation

        - Does the contract provide a broker fee for providing certain services as opposed to placement of policy? Do you stipulate an additional price for the additional services or is it included in the overall placement of the policy?
    - **Step 5**: **Recognize revenue**
        - How much of the revenue will be recognized upfront? Placement of policy vs. remaining life of the policy
            - Is there any reason to extend beyond a year if there is a multi-year policy?
- Question for the group: Are contracts broken down into simple performance obligations or do the contracts resuscitate more performance obligations (revise contracts to accommodate ASC 606)?
    - One individual stated they are looking into simple performance obligations
- Questions from the group:
    - What were some areas where you could not bundle and had to break out?
        - Depends on contract
            - If you are providing additional services for a fee which is separately stated in the contract, then this cannot really be combined as a placement on the policy.
    - Would people agree that employee benefits are more straightforward vs. P&C since most of this is direct bill and commissions are received over 12 months?
        - One attendee's response: Yes, commissions do come in monthly and interest expense is recognized as we bill it, and it's on a cash basis.
        - Another respondent: Cash basis is no longer valid for direct bill under ASC 606. The argument is that revenue is still recognized monthly because services are provided monthly: 40% in the first month and 60% over the rest of 11 months.
            - ASC 606: Anything not collected on cash basis will need to be recorded in accrual in the books as of 12/31/18 recognizing all the revenue. This should be adjusted yearly (if bank debt, then quarterly) for future installments (if purely based on placement policy).
            - P&C is more complicated as they exempt insurance carriers from ASC 606.

Dan Sebastiani: Tackling Revenue Recognition in your Agency

- What kind of approach should you consider while tackling ASC 606?
    - Understand the subject matter: ASC 606, ASC 340 and IRC 451.
        - Knowing that cash basis is no longer valid —even after revenue is recognized it may look cash based, but need to justify how it looks from accrual standpoint
    - Gather the relevant information.
        - Contracts, talking to people in the agency.
        - Understanding whether to make IT changes, changes to workflow, supplement reporting to capture all this information.
    - Evaluate how the changes will affect your agency.
    - Decide which method you will use to apply the new standards.
        - Will you be using the full or modified retrospective model? Why?
    - Build your model: internal or outsourced.
        - Do you do it at your existing management system or through the IT management team?

        - Put your model to work, verify the results and maintain it.
            - Maintain the model quarter to quarter or year to year.
                - Who will manage this process? Will you need new resources?
- Thoughts from the group:
    - Respondent: We are a part of a publicly-traded company, so we have addressed this.
        - Segregated life and health and continuing the service monthly to recognize this revenue monthly
        - Look at installment billing and agency fees on P&C side and review it quarterly and have accrual for things not recognized and month of effective date and have accrual that are reviews on contingency revenue
        - On P&C side, looked at different streams of revenue (personalized vs. materiality) and what was being recognized was immaterial
            - Direct bill was work compensation, and vast majority is based on payroll. This was justifiable and didn't need to do accrual.
        - Based the materiality on the agency
        - Did not need to provide sample of contracts because we were able to sell them on generalities of the different types of business we have.

Brian Friend: Scoping your situation – How are you impacted?

- Are there other operational/contractual items to consider with ASC 606?
    - Materiality
    - Financial statement users & frequency of accounting for this pronouncement
    - Employment agreements
        - Address contractual language when producer compensation is based on financial statement revenue
- Thoughts from the group:
    - Carrier bonuses based on new written business on calendar basis – cannot overlook this and there will be some type of accrual for this

Brain Friend: Looking at the Revenue Streams

- Revenue streams identified (P&C, Employee Benefits, Personal Lines, Profit Sharing and Other Consulting)
- Property casualty – the group provided a variety of feedback on their methodology for recognizing income. Some agencies anticipate recognizing 100% of policy commissions on the policy's effective date while other agencies have identified ongoing services that will require revenue to be recognized over the term of the policy. Each agency will need to evaluate their own unique service delivery to determine what is appropriate for them. If applicable, start engaging with your external auditors soon in order to determine the correct approach.
- Performance Obligations – When are they met? How do you determine?
    - Provide the different services and outline their performance
- Receivable for Profit Sharing Agreements?
    - Observe historic revenue received on Profit sharing agreements and accruing based on historic results.

Dan Sebastiani: ASC 340 Looking at the Cost Streams

- Costs to Obtain: Capitalize incremental costs of obtaining a contract if you expect to recover those costs – either directly reimburse under the contract or reimbursable through the expected margin.
    - These are costs that you only incur because you place the policy or executing the contract, i.e. advertising
    - Costs of comp for sales manager or account manager based on share of the revenue/placement
- Costs to Fulfill: Recognize and amortize an asset for contract fulfillment costs if they meet all conditions below:

  Relate directly to a contract or to an anticipated contract

  Generate or enhance resources used in satisfying performance obligations in the future

  Are expected to be recovered
- Thoughts from the group:

  Historically, cost to obtain is focus on revenue recognition because this is where the cost is associated with it. Cost to fulfill is involved with expensing the salaries (this cost exists regardless of anything else), so this can be expensed as incurred.

In terms of services, if benefits revenue is recognized monthly, there may not be enough of it to be material for the auditors.

- Cost of all benefits for the quarter should reflect onto the balance sheets.
- If contract term is less than a year on a personalized policy, there is no deferral.

If service center is used, the net compensation is recorded to revenue and not recognize the service center fee.

Brain Friend: Taxation Concerns – IRS Section 451 (As amended in 2018)

- IRS Section 451 – "All-events test" vs. amendment with the Tax Cuts and Jobs Act
    - There is a requirement for tax reporting to be in line with GAAP reporting. With implementation of ASC 606, there is the possibility of significant additional taxable income that would need to be addressed.
- Retrospect adjustment – guidance on whether this is considered an automatic Change in Accounting Method
    - The IRS is still working on retrospect adjustment that would be made on a financial statement would be considered an automatic change in accounting. The implication of this is that incremental income gets spread over 4 years if it is considered a change in accounting method as opposed to an accounting method that records the income in a single tax year.
    - If there is a change to the accounting method, requirements will be less burdensome to file form 3115 as it will be automatic.
- Cash flow planning for tax needs with acceleration of revenue recognition

Ending Comments

- Historically, revenue streams have been viewed when the actual service has been rendered to match expenses.
- We encourage auditors to note that the services were performed throughout the year and in terms of endorsements, recognize the revenue when it's received, if that is in fact the case.