Revenue Changes for Insurers

Insurers may see a change in revenue recognition after adopting Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers* (Topic 606). Implementation is a significant undertaking for entities across all industries; however, the insurance industry faces fewer challenges, since its major income stream is excluded from scope. The effect on each insurer will vary depending on existing income sources, customer base and accounting elections. The new guidance could lead to a change in the recognition of revenue and costs from services other than insurance contracts. Even if the amount or timing of revenue recognition does not change, presentation and disclosure may. In addition, insurers will have to redraft accounting policies under the new principles and update internal controls for any increases in management's judgments.

Effective Dates Revenue Recognition (ASC 606)

Public Entities
Annual and interim reporting periods beginning after December 15, 2017

All Others
Annual reporting periods beginning after December 15, 2018, and subsequent interim periods

The new revenue recognition model is now effective for public entities (see BKD's white paper [Revenue Recognition: An Updated Look at the Guidance]). This paper focuses on those items in the new model that will have the greatest effect on insurers and includes all subsequent amendments, Transition Resource Group clarifications, finalized and exposed guidance from the American Institute of CPAs Insurance Entities Revenue Recognition Task Force (Task Force) and U.S. Securities and Exchange Commission (SEC) views gathered from official speeches. After lengthy, costly and time-consuming implementation efforts, most insurance filers did not see a material change to the bottom line or to the timing or pattern of revenue recognition for major income streams. Below are key themes noted in recent 10-Q filings after the initial adoption of Accounting Standards Codification (ASC) 606.

Scope

One of the first challenges for insurers is identifying whether a contract is partially or entirely within ASC 606's scope. ASC 606 applies to all customer contracts, except for those within the scope of other standards, *e.g.*, insurance contracts, financing arrangements and financial instruments.

All contracts within the scope of ASC 944, *Financial Services—Insurance*, are excluded from the new revenue rules. However, certain products offered by insurance companies may be within ASC 606's scope, if they are offered without insurance coverage. Contracts may be partly within the scope of ASC 606 and another standard. If the other standard specifies how to separate and/or initially measure one or more parts of the contract, an entity should first apply the separation and/or measurement guidance from that standard.

Typical ASC 606 Income Streams for Insurance Companies	
Prepaid legal plans*	Administrative-only contracts*
Distribution and administrative service fees	Fee-based investment management services
Consumer protection plans*	Roadside assistance*
Mail order pharmacy	Network access fees

*If offered without insurance

Proper scope assessment ensures the correct accounting guidance is applied and also proper income statement presentation—any income streams not in ASC 606's scope must be broken out separately in the financial statements.

AIG

The standard excludes from its scope the accounting for insurance contracts, leases, financial instruments and certain other agreements that are governed under other GAAP guidance, but could affect the revenue recognition for certain of our other activities.

Our analysis of revenues indicated that substantially all of our revenues were from sources excluded from the scope of the standard. For those revenue sources within the scope of the standard, there were no material changes in the timing or measurement of revenues based upon the guidance. As substantially all of our revenue sources were excluded from the scope of the standard, the adoption of the standard did not have a material effect on our reported consolidated financial condition, results of operations, cash flows or required disclosures.

MetLife

*For the three months ended March 31, 2018, the Company identified $322 million of revenue streams within the scope of the guidance that are all included within other revenues on the interim condensed consolidated statements of operations and comprehensive income (loss). Such amount primarily consists of **prepaid legal plans and administrative-only contracts**, **distribution and administrative services fees** and **fee-based investment management services**.*

Allstate

***Insurance contracts are excluded from the scope of the new guidance**. The Company's principal activities impacted by the new guidance are those related to the issuance of **protection plans for consumer products and automobiles and service contracts that provide roadside assistance**.*

Hartford Life Insurance Company

*The Company earns revenues from these contracts primarily for **administrative and distribution services** fees from offering certain fund families as investment options in its variable annuity products.*

Mortgage Insurance Contracts

ASC 944 provides a scope exception for mortgage guaranty insurance entities, but there is no other specific guidance. As a result, industry-specific practice has developed. There was initial concern that mortgage insurance contracts—because they were excluded from ASC 944's scope—would then be covered by ASC 606, nullifying current accounting practice. To resolve this issue, FASB issued a set of technical corrections in 2016. The basis for conclusion states, "This exclusion applies to contracts within the scope of Topic 944 such as life and health insurance, property and liability insurance, title insurance, and mortgage guarantee insurance." Therefore, mortgage guarantee insurance contracts are not subject to ASC 606.

> *Genworth Financial*
>
> *The Financial Accounting Standards Board (FASB) has clarified the scope that* ***all of our insurance contracts, including mortgage insurance and investment contracts, are excluded from the scope of this new guidance****.*

Fulfillment Costs

ASC 944 does not explicitly specify whether or how to separate and/or initially measure service components of every insurance contract, *e.g.*, claims adjudication and settlement services might be performed by an insurer relating to claims that fall below a certain deductible amount. Under current practice, if the activity is part of fulfilling the insurance obligation or mitigating the insurer's risk, regardless of whether it also might provide a service to the policyholder, the contract is typically accounted for in its entirety as an insurance contract under ASC 944. FASB's technical corrections further clarified its intent, "There could be other activities in the contract, such as insurance risk mitigation or cost containment activities that relate to costs to fulfill the contract within the scope of Topic 944. Those fulfillment activities would not be within the scope of Topic 606 and, instead, similar to current practice, would be considered part of the contract within the scope of Topic 944."

The AICPA Task Force developed a list of examples of fulfillment activities that should be considered part of the contract within the scope of ASC 944:

- Claims adjudication and processing
- Health insurance contracts covered by ASC 944. Additional activities related to the fulfillment of the insurance contract may include enrollment (for group plans), provider network access, routine physicals and screenings, immunizations, preventive care and wellness benefits, transportation to facilities for treatment, access to durable medical equipment (such as wheelchairs and crutches) and wellness benefits that include biometric screening, tobacco cessation, personal health assessments and records, health coaching and disease management
- Safety inspections
- Roadside assistance
- Cybersecurity activities
- Title search provided with a title policy

> *If the services noted above are offered without an insurance element, they should be accounted for under ASC 606.*

Claim Adjudication & Processing

Management judgment will be required in evaluating whether claim adjudication and process activities are part of the fulfillment activities of an insurance contract. These services are most frequently found in high-deductible property casualty contracts. Under these policies, coverage only is provided for claims above a specified deductible amount, and the customer may obtain claim adjudication and processing from a third party. The third party would be subject to ASC 606.

> *Each contract is unique, and management should consider all the facts and circumstances in its scope conclusions. Management should develop sufficient supporting documentation to support its conclusions for auditors.*

The Model

The revenue recognition model's core principle is that an entity would recognize as revenue the amount that reflects the consideration to which it expects to be entitled in exchange for goods or services when (or as) it transfers control to the customer. To achieve that core principle, an entity will apply a five-step model:

- Identify the contract(s) with a patient
- Identify the separate performance obligations
- Determine the transaction price
- Allocate the transaction price to the separate performance obligations
- Recognize revenue when or as a performance obligation is satisfied

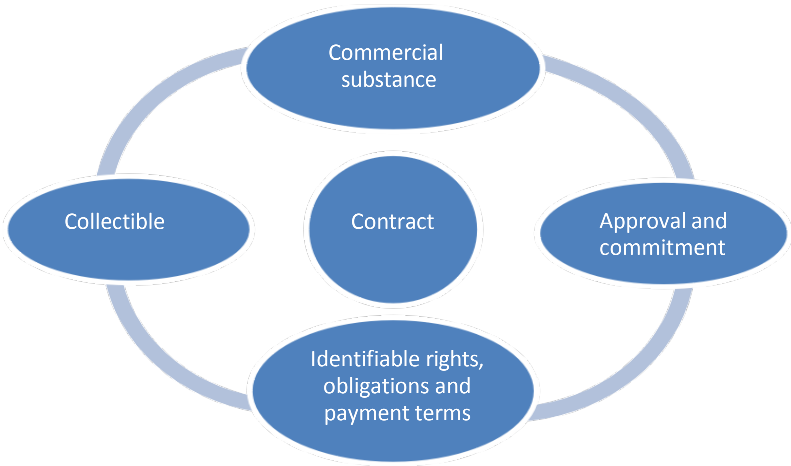
Portfolio Approach

FASB recognized the challenges of applying the new revenue rules on a contract-by-contract basis and provided a practical expedient for entities with a large volume of similar contracts or with similar customer classes. Insurers can apply the practical expedient if the portfolio has similar characteristics and the entity reasonably expects that the effects will not differ materially from applying the guidance to individual contracts. Because this is a practical expedient and not a requirement, an entity can choose to apply it to certain classes of contracts and use it on an individual contract basis for others. The expedient is available for all aspects of the model or only to certain steps. Large organizations can adopt a portfolio approach on a systemwide or entity basis.

In establishing portfolios, an insurer will need to use judgment to determine the size, composition and number of portfolios. Each organization is unique, and portfolios will depend on the customer base and accounting system capabilities. Entities should consider the experience with and homogeneity of the portfolio to ensure the data is useful to predict an expected outcome. Entities should have documentation to support judgments and assumptions in determining portfolios.

Step 1 – Identify the Contract with a Customer

The new revenue standard defines a contract as "an agreement between two or more parties that creates enforceable rights and obligations." Accounting for contracts with customers under the new model only begins when all the following criteria are met:



Contract identification is relatively straightforward for insurers. Insurers with multiple service lines may need to consider new ASC 606 guidance on combining contracts.

Combining Contracts

Contracts entered into at or near the same time with the same customer (or related parties) should be combined if one or more of the following criteria are met:

- Contracts are negotiated together with a single commercial objective
- Pricing interdependencies exist between contracts
- Goods or services in the contracts represent a single performance obligation (see Step 2 – Identify Performance Obligations)

Chapter 14 of the 2017 AICPA Audit and Accounting Guide on Revenue Recognition addressed contract combinations of administrative services only (ASO) contracts offered with stop-loss insurance contracts. An insurance entity may enter into an ASO 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 for either contract, this may suggest a pricing interdependency under which these contracts may need to be treated as one arrangement. Although this contract combination guidance is not applicable to contracts outside ASC 606's scope, 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 the contracts should be combined, an entity should then 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 the activities are predominantly performed as part of fulfilling the insurance obligation or mitigating the insurer's insurance risk, the Task Force believes the combined contracts should be accounted for as one contract under ASC 944. If the activities of the combined contract are not predominantly performed as part of fulfilling the insurance obligation or mitigating the insurer's insurance risk, the Task Force believes ASC 606 guidance should be applied to determine the allocation of the combined consideration between noninsurance performance obligations to be accounted for under ASC 606 and insurance coverage (see Step 4).

Step 2 – Identify Performance Obligations

Contracts need to be reviewed to identify all the services and goods that have been promised, known as performance obligations. An insurer is not required to identify goods or services promised to the customer that are immaterial in the context of the contract. A good or service is distinct only if:

- The customer can benefit from the good or service, either on its own or together with other readily available resources, *i.e.*, the goods or services are capable of being distinct; and
- The good or service is separately identifiable from other promises in the contract, *i.e.*, the good or service is distinct within the context of the contract

Insurers often provide other services in addition to insurance or asset management that may be provided on a standalone basis rather than as an integrated component of insurance coverage. A service contract might contain more than one performance obligation. The different performance obligations—and term associated with each—require an insurer to determine the allocation of consideration and revenue recognition patterns for each performance obligation identified.

Step 3 – Determine Transaction Price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. To determine the transaction price, an entity would consider the contract's terms, its customary business practices and the effects of the time value of money, noncash consideration and consideration payable to the customer. Consideration may include fixed amounts, variable amounts or both.

Transaction Price				
Total Amount of Consideration to Which an Entity Expects to Be Entitled				
Variable consideration	Constraining estimates of variable consideration	Significant financing	Noncash consideration	Consideration payable to a customer

Variable Consideration

Variable consideration included in the transaction price is subject to a constraint. An insurer should include variable consideration in the transaction price 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 when the uncertainty is resolved. Factors to be considered in the assessment include whether the variability is significantly influenced by factors outside the entity's influence (such as market factors or the actions of third parties), the length of time the uncertainty is likely to exist, the entity's experience with similar transactions and the number and range of outcomes.

Insurance entities might provide other services that have variable consideration, *e.g.*, performance fees for claim management services. The recognition of revenue for these services might need to change, depending on an insurance entity's current practice compared to the new requirement to determine whether the revenue is subject to significant reversal.

MetLife

*Substantially all of the revenue from these services is **recognized over time** as the applicable services are provided or are made available to the customers and control is transferred continuously. The consideration received for these services is **variable and constrained** to the amount not probable of a significant revenue reversal.*

Cigna

The Company may also provide performance guarantees that provide potential refunds to clients if certain service standards, clinical outcomes or financial metrics are not met. If these standards, outcomes and metrics are not met, the Company may be financially at risk up to a stated percentage of the contracted fee or a stated dollar amount. The Company defers revenue and records a liability for estimated payouts associated with these guarantees within accounts payable, accrued expenses and other liabilities. ***The amount of revenue deferred is estimated for each type of guarantee, using either a most likely amount or expected value method depending upon the nature of the guarantee and the information available to estimate refunds. Estimates are refined each reporting period as additional information on the Company's performance becomes available, and upon final reconciliation and settlement at the end of the guarantee period****. Amounts accrued and paid for performance guarantees during the reporting periods were not material.*

Step 4 – Allocate Transaction Price to Separate Performance Obligations

If a contract includes separate performance obligations, insurers would allocate the transaction price to performance obligations based on the relative standalone selling price of separate performance obligations. The best evidence of standalone selling price would be the observable price for which the entity sells goods or services separately. If an entity does not have separately observable sales, it should estimate the standalone selling price by using observable inputs and considering all information reasonably available to the entity. The objective would be to allocate the transaction price to each performance obligation in an amount that represents the consideration the entity expects to receive for its goods or services.

Step 5 – Recognize Revenue

Insurers recognize revenue for ASC 606 income streams when (or as) a performance obligation is satisfied by transferring a promised good or service to a customer. If the performance obligations are satisfied at a point in time, the associated revenue would be recognized at that point in time. Entities would recognize revenue for a performance obligation satisfied over time using a method that best depicts the transfer of goods or services. Assessing whether a transaction meets the criteria to recognize revenue over time will be a key accounting judgment.

Revenue Presentation

Any income streams that are not in ASC 606's scope must be separately identified on the income statement.

Principal Versus Agent

If other parties are involved in providing goods or services to an insurer's customer, the insurer must determine whether it is acting as a principal or an agent. Distinguishing between principal and agency roles requires significant judgment and can be challenging even under current guidance. This distinction is important because it determines if revenue is recognized on a gross or net basis. If the nature of a promise is to **provide** a good or service to the customer, then the entity is a principal and would recognize gross revenue. If the nature of the promise is to **arrange** for the good or service to be provided to the customer by the other party, then the entity is an agent and would recognize net revenue.

An entity must first identify the specified good or service provided to the customer, *e.g.*, good, service or a right to a good or service, and then determine if it is a principal or agent for each promised good or service. If a customer contract includes more than one good or service, an entity could be a principal for some items and an agent for others.

The indicators in ASC 606 may be more or less relevant or persuasive to the control assessment, depending on the facts and circumstances. When another party is involved in providing goods or services to a customer, an entity that is a principal obtains control of any one of the following:

- A good or another asset from the other party that it then transfers to the customer
- A right to a service to be performed by the other party, which gives the entity the ability to direct that party to provide the service to the customer on the entity's behalf
- A good or service from the other party that it then combines with other goods or services in providing the specified good or service to the customer

Indicators that an entity controls the specified good or service before it is transferred to the customer—and is therefore a principal—include, but are not limited to, the following:

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service. If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf
- The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer, *e.g.*, if the customer has a right of return
- The entity has discretion in establishing the price for the specified good or service. Establishing the price the customer pays for the specified good or service may indicate the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers

Aetna

As a result of adopting this new guidance, fees and other revenue, cost of products sold and operating expenses increased by $435 million, $373 million and $62 million, respectively, for the three months ended March 31, 2018, primarily related to modifications to principal versus agent guidance for our home delivery and specialty pharmacy operations. There were no material changes in the timing of our recognition of revenue or net income.

Allstate

In addition to the net cumulative effect, the Company also recorded in the statement of financial position an increase of approximately $160 million pre-tax in unearned premiums with a corresponding $160 million pre-tax increase in DAC for protection plans sold directly to retailers for which SquareTrade is deemed to be the ***principal*** *in the transaction. These impacts offset fully and did not impact retained income at the date of adoption.*

ASO/ASC Contracts

An administrative service contract (ASC) is similar to an ASO contract except for how the claims are paid and funded. Under an ASO agreement, claims are paid from a bank account owned and funded directly by the plan sponsor, or claims are paid from an administrator-owned bank account, but only after the administrator has received funds from the plan sponsor. Under an ASC plan, the administrator pays claims from its own bank account and subsequently receives reimbursement from the plan sponsor.

In general, most ASO/ASC contracts meet the control requirements to be considered a principal. The nature of the administrator's promise is to provide claims management and reimbursement services to the customer (plan sponsor). In the GAAP financial statements, the revenue (administrative fees) should be reported as revenue on the income statement and expenses to provide those services should be included in operating expenses.

For some ASC administrators, ASC 606 may require a change in presentation. Some nonpublic ASC administrators currently report gross claims reimbursements received and gross claims incurred to arrive at a net revenue subtotal. After adoption of ASC 606 to issue financial statements in accordance with GAAP, revenues from these types of contracts should be presented net in the income statement, while the information on claims processed for others can be disclosed in the footnotes to the financial statements.

Cigna

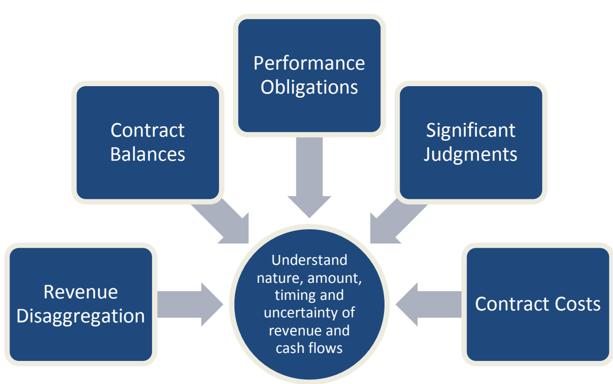
The majority of the Company's service fees are derived from administrative services only ("ASO") arrangements that allow corporate clients to self-fund claims and assume the risk of medical or other benefit costs. In return for fees from these clients, the Company provides or makes available various services supporting benefit management and claims administration. In addition, Global Health Care's services include access to the Company's participating provider networks, disease management, utilization management and cost containment services.

In general, the Company considers these services to be a ***combined performance obligation*** *to provide cost effective administration of plan benefits over the contract period. Fees are billed, due and recognized monthly at contracted rates based on current membership or utilization. This recognition pattern aligns with the benefits from services provided to clients.*

Expenses associated with administrative programs and services are recognized in other operating expenses as incurred.

Disclosures

Companies in all industries that have early adopted the new revenue standard have found this area to be more challenging than initially anticipated. The new revenue standard provides significant relief for nonpublic entities and less focus on quantitative disclosures. In most cases, additional data will need to be collected and additional monitoring and record-keeping will be required. If applicable, BKD has prepared a separate white paper on the new required disclosures that applies to all industries, Revenue Recognition: New Disclosures. For most insurers, noninsurance income was not material and no additional disclosures were required, or brief qualitative language was included with transition disclosures.



Adoption

Entities must adopt the new revenue standard using either a full or modified retrospective approach with multiple practical expedients offered to provide transition relief. Under the full retrospective approach, entities would apply ASC 606 as if it had been in effect since the inception of all customer contracts. Under the modified approach, the cumulative effect of initial application is recognized in opening retained earnings at the adoption date. Relief is provided so an entity could apply the new revenue standard either to all contracts as of the adoption date or only to uncompleted contracts. Annual 10-K filings revealed that most insurers chose a modified retrospective approach to adoption, *e.g.*, AIG, MetLife, Allstate and Genworth; however, one large insurer, Cigna, chose a full retrospective approach. Each approach has relative benefits, costs and complexities. There is no one-size-fits-all solution—it will depend on each insurer's specific facts and circumstances and which factors are most relevant. Some insurers may consider comparability to peers or between reporting periods to be most relevant, while others may prioritize the cost of implementation. In other cases, an entity may consider comparability most important but determine the retrospective method is not feasible because it cannot make the necessary system changes in the required time frame at a reasonable cost.

Conclusion

The adoption of ASC 606 will be complex and likely will require significant hours to correctly implement. If you would like assistance in complying with the new standard, contact your trusted BKD advisor. BKD has prepared a library of **BKD Thoughtware®** on this issue. Visit our Hot Topics page to learn more.

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