Revenue Changes for Insurance Brokers

Insurance brokers will see a change in revenue recognition after adopting Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers* (Topic 606), which is now effective for public entities[1] (see BKD's white paper [Revenue Recognition: An Updated Look at the Guidance]). Implementation is a significant undertaking for entities across all industries. The effect on each broker will vary depending on existing income sources and customer base. In general, Accounting Standards Codification (ASC) 606 will affect brokering fees more than consulting fees, unless there is variable- or performance-based compensation. The new guidance could lead to a change in the timing of revenue recognition and increase in costs capitalized. For all insurance brokers, presentation and disclosure will change. In addition, all entities 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

This paper focuses on those items in the new model that will have the greatest effect on insurance brokers and includes all subsequent amendments, Transition Resource Group (TRG) clarifications and U.S. Securities and Exchange Commission (SEC) views gathered from official speeches. Below are key themes noted in 10-Q filings:

- **Timing of Revenue** – The new revenue recognition standard will most likely shift revenue among quarters due to changes in the timing of recognition. For example, revenue on insurance placements is generally recognized on the later of billing or effective date. Under ASC 606, revenue will be recognized largely at the policy effective date
- **Variable Consideration** – Under ASC 606, entities are required to estimate variable or contingent consideration to be received, which will result in revenue being recognized earlier than under current guidance
- **Contract Costs** – ASC 606 requires the capitalization and amortization of certain contract acquisition and fulfillment costs, which were expensed as incurred under legacy generally accepted accounting principles (GAAP). For costs that continue to be capitalized, the amortization period may need to be updated to reflect the contract term plus expected renewals
- **Contract Asset/Liability** – This is a new concept for most industries. Under existing guidance, when revenue is recognized but not yet billed, an entity records an asset for unbilled accounts receivable. After an invoice is sent to the customer, the related balance is reclassified as billed accounts receivable. Under Topic 606, reclassification from a contract asset to a receivable is contingent on fulfilling performance obligations—not on invoicing a client

[1] *A public entity is defined as any one of these:*
- *A public business entity*
- *A not-for-profit entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market*
- *An employee benefit plan that files or furnishes financial statements to the SEC*

Marsh Inc.

Upon adoption of the new revenue standard, the Company recognized significant movement in the quarterly timing of revenue recognized in the Risk and Insurance Services segment. In particular, under the new standard the recognition of revenue for reinsurance broking was accelerated from historical patterns. Estimated revenue from these treaties is recognized largely at the policy effective date at which point control over the services provided by the Company transfers to the client and the client has accepted the services. Prior to the adoption of this standard, revenue related to most reinsurance placements was recognized on the later of billing or effective date as premiums are determined by the primary insurers and attached to the reinsurance treaties. Typically, this resulted in revenue being recognized over a 12- to 18-month period.

Willis Towers Watson

• Medicare Broking — The majority of revenue recognition for this offering, within our Individual Marketplace business, has moved from monthly ratable recognition over the policy period, to recognition upon placement of the policy

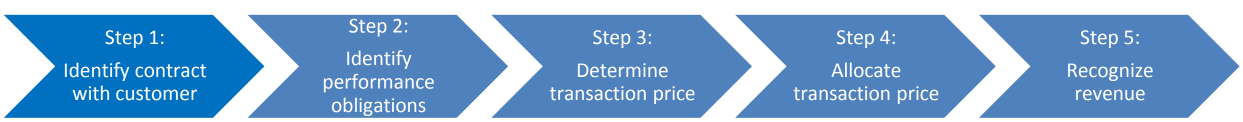
• Proportional Treaty Reinsurance Broking — The revenue recognition for proportional treaty reinsurance broking commissions, has moved from recognition upon the receipt of the monthly or quarterly treaty statements from the ceding insurance carriers, to the recognition of an estimate of expected commissions upon the policy effective date

Aon

The Standard provides guidance on accounting for certain revenue-related costs, including when to capitalize costs associated with obtaining and fulfilling a contract. The majority of these costs were previously expensed as incurred under ASC 605.

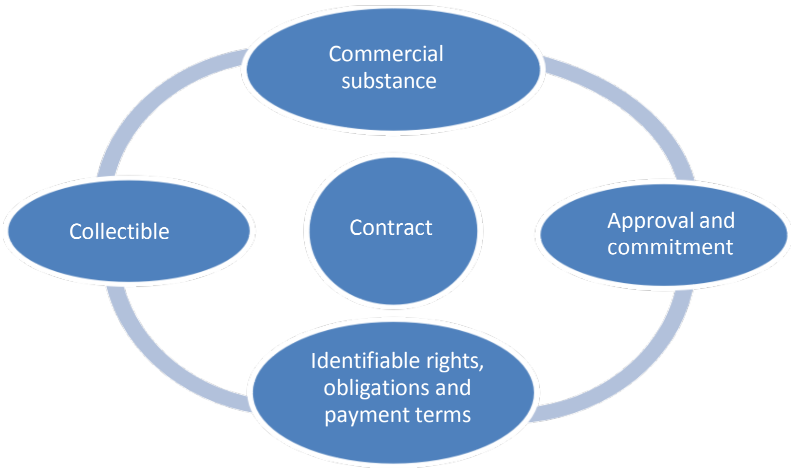
The Model

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:



Step 1: Identify Contract with 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 begins only when all the following criteria are met:



For insurance brokers, the identification of the contract and terms is straightforward. The inception date may need to be reconsidered in certain circumstances.

Willis Towers Watson

Due to the nature of the majority of our broking arrangements, no single document constitutes the contract for ASC 606 purposes. Our services may be governed by a mixture of different types of contractual arrangements depending on the jurisdiction or type of coverage, including terms of business agreements, broker-of-record letters, statements of work or local custom and practice. This is then confirmed by the client's acceptance of the underlying insurance contract. Prior to the policy inception date, the client has not accepted nor formally committed to perform under the arrangement, i.e., pay for the insurance coverage in place. Therefore, in the majority of broking arrangements, the contract date is the date the insurance policy incepts. However, in certain instances such as Medicare broking or Affinity arrangements, where the employer or sponsoring organization is our customer, client acceptance of underlying individual policy placements is not required, and therefore, the date at which we have a contract with a customer is not dependent upon placement.

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 insurance broker 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

A contract might contain more than one performance obligation. The different performance obligations—and terms associated with each—require an insurance broker to determine the allocation of consideration and revenue recognition patterns for each performance obligation identified (see Step 4).

Marsh Inc.

*For the majority of the insurance and reinsurance brokerage arrangements, advice and services provided which culminate in the placement of an effective policy are considered a **single performance obligation**.*

Willis Towers Watson

*In assessing our performance obligations, our consulting work is typically highly integrated, with the various promised services representing inputs of the combined overall output. We view these arrangements to represent a **single performance obligation**. To the extent we do not integrate our services, as is the case with unrelated services that may be sourced from different areas of our business, we consider these separate performance obligations.*

Stand-Ready Obligations

A contract may include "a service of standing ready to provide goods or services or of making goods or services available for a customer to use as and when the customer decides." The promise in a stand-ready obligation is the assurance the customer will have access to the good or service, not the delivery of the underlying good or service. This conclusion determines the pattern of revenue recognition in Step 5.

Willis Tower Watson

Stand-ready obligations. These projects consist of repetitive monthly or quarterly services performed consistently each period. As none of the activities provided under these services are performed at specified times and quantities, but at the discretion of each customer, our obligation is to stand ready to perform these services on an as-needed basis. These arrangements represent a 'series' performance obligation in accordance with ASC 606. Each time increment, i.e., each month or quarter, of standing ready to provide the overall services is distinct and the customer obtains value from each period of service independent of the other periods of service.

*Ongoing administration phase. The ongoing administration phase includes a variety of plan administration services, system hosting and support services. More specifically, these services include data management, calculations, reporting, fulfillment/communications, compliance services, call center support and annual onboarding and enrollment support. While there are a variety of activities performed, the overall nature of the obligation is to provide an integrated outsourcing solution to the customer. The arrangement represents a **stand-ready obligation** to perform these activities on an as-needed basis. The customer obtains value from each period of service, and each time increment, i.e., each month, or each benefits cycle in our health and welfare arrangements, is distinct and substantially the same. Accordingly, the ongoing administration services represent a '**series**' in accordance with ASC 606 and are deemed one performance obligation.*

Series Provision

The series provision is a new concept that does not exist in current GAAP. It requires goods or services to be accounted for as a single performance obligation in certain instances, even though the underlying goods or services are distinct. A series of distinct goods or services should be accounted for as a single performance obligation if they are substantially the same, have the same pattern of transfer and both of the following criteria are met:

- Each distinct good or service in the series represents a performance obligation that will be satisfied over time (Step 5)
- The entity would measure its progress toward satisfaction of the performance obligation using the same measure of progress for each distinct good or service in the series

Entities will need to determine whether a single performance obligation is created in this manner to appropriately allocate variable consideration (Step 4). This provision prevents an entity from having to allocate the transaction price on a relative standalone selling price basis to each increment of a distinct service in repetitive service contracts. The series guidance also must be applied even when there is a gap or overlap in an entity's transfer of goods or services if the other criteria are met.

> ***Marsh Inc.***
>
> *Health brokerage and consulting services are components of both Marsh, which includes MMA, and Mercer, with approximately 70 percent of such revenues reported in Mercer.* ***Health contracts typically involve a series of distinct services that are treated as a single performance obligation****. Revenue for these services is recognized over time based on the amount of remuneration the Company expects to be entitled in exchange for these services.*

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 terms of the contract, 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 insurance broker 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 likely is to exist, the entity's experience with similar transactions and the number and range of outcomes. This will be a significant management judgment and detailed disclosure will be required if the amounts are material.

Commissions & Renewals

Brokers or agents commonly enter into delegated authority agreements with insurance companies, whereby they perform the underwriting of insurance policies for the insurer based on specific guidelines. The broker is entitled to commission revenue from the customer for the policy placement and revenue from the insurer for the underwriting services provided. A broker will sometimes receive commission payable both at inception of an underlying insurance contract and its subsequent renewal(s). The consideration from the insurer can be variable based on the underlying profitability of the business generated (profit commission) or the volumes of contracts introduced to the insurer (volume overrider). These contingent commissions can be finalized several years after the initial policies are written.

The new guidance could lead to an acceleration of recognition of revenue when a broker is entitled to contingent or renewal commissions, and there are no further implied or contractual services to be performed in the renewal periods. In Step 5, the performance obligation relating to the initial placement is satisfied when the terms of the insurance policy have been agreed contractually by the insurer and policyholder, and the insurer has a present right to payment from the policyholder. The fact that the commissions received are contingent on a future event does not affect the assessment of whether the performance obligation has been satisfied. Therefore, the transaction price at the transaction date of the initial insurance contract would include both initial commission and subsequent expected renewal commissions that do not represent a separate performance obligation and would be recognized as revenue at that date, but only if it is probable that there will not be a significant reversal of the revenue for renewal commissions. The recognition of the initial commission and renewal commissions should be carefully analyzed in the five-step model to determine if it is appropriate to recognize an estimate for renewals at the placement of the original policy. The analysis should determine if the renewal represents a separate performance obligation and reliable data exists to show probable renewals.

Trailing Commission Example

An insurance broker receives trailing commissions of $100 every time a consumer signs up for a new insurance policy and $50 whenever one of those consumers renews a policy. The broker has a large pool of historical data about customer renewal patterns, given its significant experience with similar contracts. The consideration is highly susceptible to factors outside its influence, and the uncertainty could stretch out over multiple years. However, it also has significant experience with similar types of contracts, and its experience has predictive value.

As a result, even though the amount of consideration the entity will be entitled to is uncertain and depends on the actions of third parties, i.e., customer renewals, the entity likely can estimate a minimum amount of variable consideration for which it is probable that a significant reversal of cumulative revenue will not occur. Assuming the broker's performance is complete upon the initial signing of a contract, the broker would recognize the initial $100 fee plus the amount related to future renewals that is not constrained.

For brokers, some revenues might be recognized sooner than under the existing guidance.

Marsh Inc.

The Company may also be eligible for certain contingent commissions from insurers based on the attainment of specified metrics, i.e., volume and loss ratio measures, relating to Marsh's placements. Revenue for contingent commissions from insurers is estimated based on historical evidence of the achievement of the respective contingent metrics and recorded as the underlying policies that contribute to the achievement of the metric are placed. Due to the uncertainty of the amount of contingent consideration that will be received, the estimated revenue is constrained to an amount that is probable to not have a significant negative adjustment. Contingent consideration is generally received in the first quarter of the subsequent year.

Revenue related to reinsurance brokerage for excess of loss ("XOL") treaties is estimated based on contractually specified minimum or deposit premiums, and adjusted as additional evidence of the ultimate amount of brokerage is received. Revenue for quota share treaties is estimated based on indications of estimated premium income provided by the ceding insurer. The estimated brokerage revenue recognized for quota share treaties is constrained to an amount that is probable to not have a significant negative adjustment. The estimated revenue and the constraint are evaluated as additional evidence of the ultimate amount of underlying risks to be covered is received over the 12 to 18 months following the effective date of the placement.

Brown & Brown Insurance

Profit-sharing contingent commissions – Prior to the adoption of Topic 606, revenue that was not fixed and determinable because a contingency existed was not recognized until the contingency was resolved. Under Topic 606, the Company must estimate the amount of consideration that will be received in the coming year such that a significant reversal of revenue is not probable. Profit-sharing contingent commissions represent a form of variable consideration associated with the placement of coverage, for which we earn commissions and fees. In connection with Topic 606, profit-sharing contingent commissions are estimated with a constraint applied and accrued relative to the recognition of the corresponding core commissions. The resulting effect on the timing of recognizing profit-sharing contingent commissions will now more closely follow a similar pattern as our commissions and fees with any true-ups recognized when payments are received or as additional information that affects the estimate becomes available.

Willis Towers Watson

In situations in which our fees are not fixed but are variable, we must estimate the likely commission per policy, taking into account the likelihood of cancellation before the end of the policy. For Medicare broking, Affinity arrangements and proportional treaty reinsurance broking, the commissions to which we will be entitled can vary based on the underlying individual insurance policies that are placed. For proportional treaty reinsurance broking in particular, we base the estimate of transaction prices on supportable evidence from an analysis of past transactions, and only include amounts that are probable of being received or not refunded (referred to as applying 'constraint' under ASC 606). This results in us estimating a transaction price that may be significantly lower than the ultimate amount of commissions we may collect. The transaction price is then adjusted over time as we receive confirmation of our remuneration through receipt of treaty statements.

Although our per-participant-per-month and commission-based fees are considered variable, they are typically predictable in nature, and therefore, we generally do not 'constrain' any portion of our transaction price estimates.

Step 4 – Allocate Transaction Price to Separate Performance Obligations

If a contract includes separate performance obligations, an entity 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. Several approaches are available:

- **Adjusted market assessment** – An entity would evaluate the market and estimate the price customers would pay. Competitors' price information might be used and adjusted for an entity's costs and margins
- **Cost-plus margin** – An entity would forecast its expected cost to provide goods or services and add an appropriate margin to the estimated selling price
- **Residual value** – An entity would subtract the sum of observable standalone selling prices for other goods and services promised in the contract from the total transaction price to find an estimated selling price for a performance obligation. The residual value approach would be appropriate only if the selling price is highly variable or uncertain, *e.g.*, a new product

Brown & Brown Insurance

If there are other services within the contract, the Company estimates the standalone selling price for each separate performance obligation, and the corresponding apportioned revenue is recognized over a period of time as the performance obligations are fulfilled. In situations where multiple performance obligations exist within a contract, the use of estimates is required to allocate the transaction price on a relative standalone selling price basis to each separate performance obligation.

Marsh Inc.

Arrangements with clients may include the placement of a single policy, multiple policies or a combination of policy placements and other services. Consideration related to such "bundled arrangements" is allocated to the individual performance obligations based on their relative fair value. Consideration for fee arrangements covering multiple insurance placements, the provision of risk management and/or other services was allocated to all deliverables on the basis of the relative selling prices.

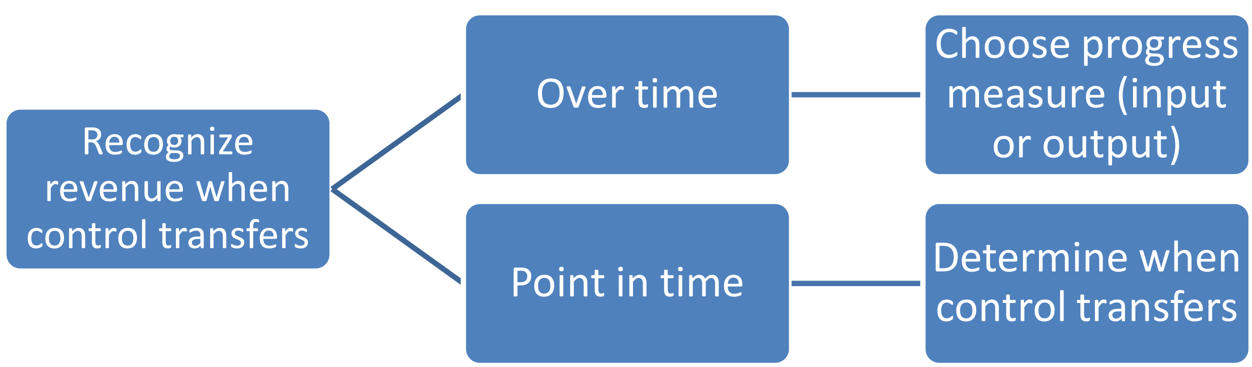
Willis Towers Watson

Where we have material post-placement services obligations, we estimate the relative fair value of the post-placement services using either the expected cost plus-margin or the market assessment approach.

Step 5: Recognize Revenue

Insurance brokers will recognize revenue 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.

Based on the services provided, insurance brokers may have both point-in-time and over-time recognition as well as multiple progress measurement methods.



Performance Obligations Satisfied over Time

Over-time recognition is appropriate when any of these criteria are met:

- The customer simultaneously receives and consumes the performance obligations benefits
- The entity's performance creates or enhances an asset
- The performance does not create an asset with alternate use and the entity has an enforceable right to payment

Measuring Progress Toward Satisfaction of a Performance Obligation

Revenue can be recognized over time only if an entity can reasonably measure its progress toward completion. An entity would be permitted to recognize revenue to the extent of costs incurred until it is reasonably able to measure its progress or the performance obligation becomes onerous, *e.g.*, during a contract's early stages. An entity can use either output or input methods to measure progress, but it would be required to consistently apply that method to similar performance obligations in similar circumstances.

Output Methods

Under an output method, an entity would recognize revenue by directly measuring the value of the goods and services transferred to date to the customer. The output selected should faithfully depict the entity's progress toward satisfaction of a performance obligation. As a practical expedient, an entity could recognize revenue in the amount it is entitled to invoice, if it directly corresponds with the value of the goods or services transferred to date. The presence of an agreed-upon customer schedule payment does not mean the amount an entity has a right to invoice directly corresponds to the customer value of performance completed to date.

Input Methods

Input measures use an entity's inputs, *e.g.*, costs incurred, or time lapsed, relative to total expected inputs to satisfy a performance obligation. If inputs are incurred evenly over time, revenue would be recognized on a straight-line basis.

Entities will need to use judgment in determining the pattern of recognition and the level of disclosure detail. For public companies, the SEC has challenged boilerplate disclosure for material revenue streams. In the examples below, Marsh Inc. and Willis Towers Watson chose explicit details and language on judgments and the various measures used. Aon has chosen more generic disclosure. Several SEC comment letters have requested an explanation as to why over-time revenue recognition is the appropriate method and why it provides a faithful depiction of the transfer of services.

Marsh Inc.

*Consulting projects typically consist of a single performance obligation, which is recognized over time as control is transferred continuously to customers. Typically, revenue is recognized over time using an **input measure** of time expended to date relative to total estimated time incurred at project completion. Incurred hours represent services rendered and thereby faithfully depicts the transfer of control to the customer.*

*The contractual terms for certain fee-based brokerage arrangements meet the criteria for revenue recognition over time. For such arrangements, progress toward completion is estimated using **output measures**, which correspond to the timing of when revenue is recognized. Fees for non-risk transfer services provided to clients are recognized over time in the period the services are provided, using a proportional performance model primarily based on **input measures**. These measures of progress provide a faithful depiction of the progress toward completion of the performance obligation.*

Fees for nonrisk transfer services provided to clients are recognized over the period in which the services are provided, using a proportional performance model.

Willis Towers Watson

For our health and welfare arrangements where each benefits cycle represents a time increment under the series guidance, revenue is recognized based on proportional performance. We use an ***input measure*** *(value of labor hours worked) as the measure of progress. Given that the service is stand-ready in nature, it can be difficult to predict the remaining obligation under the benefits cycle. Therefore, the input measure is based on the historical effort expended each month, which is measured as labor cost. This results in slightly more revenue being recognized during periods of annual onboarding since we are performing both our normal monthly services and our annual services during this portion of the benefits cycle.*

The majority of our revenue from these consulting engagements is recognized over time, either because our clients are simultaneously receiving and consuming the benefits of our services, or because we have an enforceable right to payment for performance rendered to date. We use different performance measures to determine our revenue depending on the nature of the engagement:

Annual recurring projects and projects of short duration. These projects are typically straightforward and highly predictable in nature with either time-and-expense or fixed-fee terms. Time-and-expense fees are recognized as hours or expenses are incurred using the “right to invoice” practical expedient. For fixed-fee arrangements, to the extent estimates can be made of the remaining work required under the arrangement, revenues are based upon the proportional performance method, using the value of labor hours compared to the estimated total value of labor hours. We believe that cost represents a faithful depiction of transfer of value because the completion of these performance obligations is based upon the professional services of employees of differing experience levels and thereby costs. It is appropriate that satisfaction of these performance obligations considers both the number of hours incurred by each employee and the value of each labor hour worked (as opposed to simply the hours worked).

For Medicare broking, we recognize revenue over time, as we stand ready under our agreements to place retiree Medicare coverage.

Aon

Data & Analytic Services revenue consists primarily of fees for services rendered and is generally recognized over the term of the arrangement to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for those goods or services. For Data & Analytic Services arrangements recognized over time, revenue will be recognized based on a measure of progress that depicts the transfer of control of the goods or services to the customer, utilizing an appropriate input or output measure.

Commercial Risk Solutions includes retail brokerage, cyber solutions, global risk consulting and captives. Revenue primarily includes insurance commissions and fees for services rendered. Revenues will generally be recognized at a point in time upon the effective date of the underlying policy (or policies), or over the term of the arrangement to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the Company expects to be entitled in exchange for those goods or services. Revenues are recorded net of allowances for estimated policy cancellations, which are determined based on an evaluation of historical and current cancellation data.

Control Transferred at a Point in Time

Performance obligations that do not meet any of the three criteria for being satisfied over time should be accounted for at a point in time when (or as) control is transferred to a customer. When control over an asset is transferred at a single point in time, an entity would recognize revenue by evaluating when the customer obtains control.

Brown & Brown Insurance

Historically, approximately 70 percent of the Company's commissions and fees are in the form of commissions paid by insurance carriers. These commissions are earned at a point in time upon the effective date of bound insurance coverage, as no significant performance obligation remains after coverage is bound.

Marsh Inc.

Revenue for policy placement is generally recognized on the policy effective date, at which point control over the services provided by the Company has transferred to the client and the client has accepted the services.

Willis Towers Watson

We recognize revenue for most broking arrangements as of a point in time at the later of the policy inception date or when the policy placement is complete, because this is viewed as the date when control is transferred to the client.

Contract Costs

In conjunction with ASC 606, the Financial Accounting Standards Board also amended ASC 340, *Other Assets and Deferred Costs*. Outside of guidance on accounting for long-term construction contracts and certain industry-specific guidance, U.S. GAAP previously did not address the accounting for the cost of obtaining and fulfilling customer contracts; an accounting policy election determined whether such costs were capitalized or expensed. Under current GAAP, cost must be both direct and incremental to be capitalized. Under the new standard, costs must only be incremental and insurance brokers will be required to capitalize more contract costs than they currently do.

Costs of Obtaining a Contract

An insurance agency would capitalize the incremental costs of obtaining a contract if the costs are recoverable. Incremental costs are those that would not have been incurred if the contract had not been obtained, *e.g.*, commissions paid to agents. Cost an entity incurs regardless of whether it obtains a contract would be expensed as incurred. As a practical expedient, an entity can expense these incremental costs if the amortization period of those costs would be one year or less, *i.e.*, the contract term or earnings process is not greater than a year. An entity must disclose if this practical expedient is elected.

Costs to Fulfill a Contract

If the costs incurred in fulfilling a contract are not within the scope of other guidance, *e.g.*, inventory, property, plant and equipment or capitalized software, an entity would recognize an asset only if the costs meet all the following criteria:

- They directly relate to a contract or specific anticipated contract, *e.g.*, direct labor or materials
- They generate or enhance resources that would be used to satisfy performance obligations in the future
- They are expected to be recovered

Certain costs are expensed as incurred, such as most general and administrative costs and labor not reflected in the contract price. If an entity cannot distinguish the fulfillment costs that relate to future performance obligations from the costs that relate to past performance obligations, the entity would expense these costs as incurred.

Amortization

Capitalized costs to obtain and fulfill contracts would be amortized on a systematic basis consistent with the pattern of transfer of goods or services to which the asset relates. As a practical expedient, if the amortization period would be one year or less, an entity may elect to expense the costs. The asset may be amortized over more than one contract when the asset relates to goods or services that will be provided under an anticipated contract that the entity can specifically identify, *e.g.*, renewal options. TRG meeting materials provided some factors to consider when estimating the amortization period of an asset arising from the incremental costs of obtaining a customer contract:

- **Identify the contract(s) to which the commission relates** – An entity must determine whether the capitalized incremental costs relate to goods or services that only will be transferred as part of the initial contract or if the costs also relate to goods or services that will be transferred as part of a specific anticipated contract(s)
- **Determine whether a commission on a renewal contract is commensurate with the commission on the initial contract** – For commissions on renewal contracts, an entity must first determine if the "renewal" commission is commensurate with the "initial" commission. If commensurate, the asset would be amortized over the initial contract term, *i.e.*, the commission from the initial contract does not relate to the renewal contract. If not commensurate, the entity should assess the period to which the asset relates, potentially including specific anticipated contract(s)
- **Evaluate facts and circumstances to determine an appropriate amortization period** – TRG members think using an amortization period equal to the average customer term is a reasonable application of the new revenue standard unless facts and circumstances indicate otherwise

In comment letters, the SEC asked registrants to clarify how the amortization period selected for capitalized costs to obtain a contract is consistent with the transfer of goods or services to which the asset relates, and how commissions paid for contract renewals were considered in determining the amortization period. The SEC staff also asked companies to disclose the amortization period for commissions capitalized due to both initial contracts and subsequent contract renewals. Brown & Brown and Marsh disclosures are more specific than Aon's, but still may not meet SEC expectations.

Brown & Brown Insurance

Incremental cost to obtain *– The adoption of ASC 340 resulted in the Company deferring certain costs to obtain customer contracts primarily as they relate to commission-based compensation plans in the Retail Segment, in which the Company pays an incremental amount of compensation on new business. This incremental cost is deferred and amortized over a 15-year period, which is consistent with the analysis performed on acquired customer accounts.*

Cost to fulfill *– The adoption of ASC 340 resulted in the Company deferring certain costs to fulfill a contract and to recognize these costs as the associated performance obligations are fulfilled.*

Marsh Inc.

Under the new standard, certain costs to obtain or fulfill a contract that were previously expensed as incurred have been capitalized. The Company capitalized the incremental costs to obtain contracts primarily related to commissions or sales bonus payments. These deferred costs are amortized over the ***expected life of the underlying customer relationships****.*

In Risk and Insurance Services, the Company capitalizes certain pre-placement costs that are considered fulfillment costs. These costs are amortized as of a point in time when the associated revenue is recognized.

In Consulting, the Company incurs implementation costs necessary to facilitate the delivery of the contracted services. These costs are capitalized and amortized over the ***initial contract term plus expected renewal periods****.*

Willis Towers Watson

Costs to obtain customers include commissions for brokers under specific agreements that would not be incurred without a contract being signed and executed. The Company has elected to apply the ASC 606 'practical expedient' which allows us to expense these costs as incurred if the amortization period related to the resulting asset would be one year or less. The Company has no significant instances of contracts that would be amortized for a period greater than a year, and therefore, has no contract costs capitalized for these arrangements.

Costs to fulfill include costs incurred by the Company that are expected to be recovered within the expected contract period. The costs associated with our system implementation activities and consulting contracts are recorded through time entry. For our broking business, the Company must estimate the fulfillment costs incurred during the pre-placement of the broking contracts. These judgments include:

- *Which activities in the pre-placement process should be eligible for capitalization*
- *The amount of time and effort expended on those pre-placement activities*
- *The amount of payroll and related costs eligible for capitalization; and*
- *The monthly or quarterly timing of underlying insurance and reinsurance policy inception dates*

We amortize costs to fulfill over the period we receive the related benefits. For broking pre-placement costs, this is typically less than a year. In our system implementation and consulting arrangements, we include the likelihood of contract renewals in our estimate of the amortization period, resulting in most costs being amortized for a greater length of time than the initial contract term.

Aon

Costs incurred by the Company in obtaining a contract are capitalized and amortized on a systematic basis that is consistent with the transfer of the services to which the asset relates, considering anticipated renewals when applicable. Certain contract-related costs, including pre-placement brokerage costs, are capitalized as a cost to fulfill and are amortized on a systematic basis consistent with the transfer of services to which the asset relates, which is generally less than one year.

Assets recognized as costs to fulfill a contract, which include internal costs related to pre-placement broking activities, as well as other costs, will be amortized on a systematic basis that is consistent with the transfer of the services to which the asset relates. ***The amortization is primarily included in Compensation and benefits on the Condensed Consolidated Statements of Income****.*

Revenue Presentation

Any income streams that are not in ASC 606's scope must be separately identified on the income statement. The biggest change for insurance brokers is the new concept of a contract asset. This is a new requirement for most industries except construction. Under existing guidance, when revenue is recognized but not yet billed, an entity records an asset for unbilled accounts receivable. After an invoice is sent to the customer, the related balance is reclassified as billed accounts receivable. Under Topic 606, reclassification from a contract asset to a receivable is contingent on fulfilling performance obligations—not on invoicing a client. As a result, the point at which a contract asset is reclassified as a receivable may be different than the time of invoicing.

Contract Assets & Liabilities

An entity would present a contract in its statement of financial position as a contract liability, contract asset or receivable, depending on the relationship between the entity's performance and customer's performance at the reporting date. A contract liability exists if the customer has paid consideration or if payment is due as of the reporting date, but the entity has not yet satisfied the performance obligation. If an entity has transferred goods or services as of the reporting date, but the customer has not yet paid, the entity would recognize either a contract asset or receivable. An unconditional right to consideration is presented as a receivable. If an entity's right to consideration is conditioned on something other than the passage of time, an entity would recognize a contract asset. FASB felt the distinction between a contract asset and receivable provided financial statement users with relevant information about an entity's risk exposure. While both asset categories are subject to credit risk, a contract asset also is subject to other risks such as performance risk.

TRG members clarified that contract assets and liabilities are presented at the contract level and not the performance obligation level. Balances other than contract assets and liabilities, *e.g.*, trade receivables and deferred costs, are only offset if permitted by other GAAP. Contract assets and liabilities related to contracts not combined under the guidance in the revenue standard are only offset if allowed by other GAAP.

Entities are permitted to use different descriptions of contract assets, contract liabilities and receivables and could use additional line items to present those assets and liabilities if the entity also provides sufficient information for financial statement users to distinguish them.

Brown & Brown Insurance

Unbilled receivables (contract assets) arise when the Company recognizes revenue for amounts which have not yet been billed in our systems. Deferred revenue (contract liabilities) relates to payments received in advance of performance under the contract before the transfer of a good or service to the customer.

Prior to the adoption of Topic 606, commission revenues, including those billed on an installment basis, were recognized on the latter of the policy effective date or the date that the premium was billed to the client. As a result of the adoption of Topic 606, certain revenues associated with the issuance of policies are now recognized upon the effective date of the associated policy. These commission revenues, including those billed on an installment basis, are now recognized earlier than they had been previously. Revenue is now accrued based upon the completion of the performance obligation, thereby creating a current asset for the unbilled revenue, until such time as an invoice is generated, which typically does not exceed 12 months. The Company does not expect the overall impact of these changes to be significant on a full-year basis, but the timing of recognizing revenue will impact our fiscal quarters when compared to prior years.

Marsh Inc.

The Company records accounts receivable when the right to consideration is unconditional, subject only to the passage of time. Contract assets primarily relate to quota share reinsurance brokerage and contingent insurer revenue. The Company does not have the right to bill and collect revenue for quota share brokerage until the underlying policies written by the ceding insurer attach to the treaty. Estimated revenue related to achievement of volume or loss ratio metrics cannot be billed or collected until all related policy placements are completed and the contingency is resolved. Contract assets are included in other current assets in the Company's consolidated balance sheet. Contract liabilities primarily relate to the advance consideration received from customers. Contract liabilities are included in other current liabilities in the Company's consolidated balance sheet.

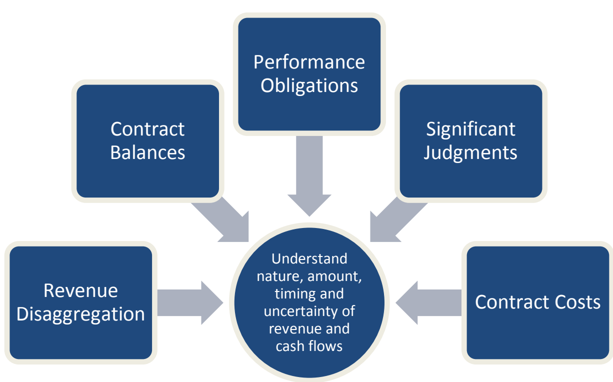
Willis Towers Watson

The Company receives payments from customers based on billing schedules or terms as written in our contracts. Those balances denoted as contract assets relate to situations where we have completed some or all performance under the contract; however, our right to consideration is conditional. Contract assets result most materially in our Medicare broking business and proportional treaty broking business. Billed and unbilled receivables are recorded when the right to consideration becomes unconditional. Deferred revenue relates to payments received in advance of performance under the contract, and is recognized as revenue as (or when) we perform under the contract.

Accounts receivable, net, now includes receivables that have been billed, not yet billed and short-term contract assets. This adjustment is the result of the cumulative adjustments to revenue that have not yet been collected from our customers, but are expected to be collected within the next 12 months.

Disclosures

Companies in all industries that have adopted ASC 606 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. BKD has prepared a separate white paper on the new required disclosures that applies to all industries, Revenue Recognition: New 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 most insurance brokers chose a modified retrospective approach to adoption, including Marsh Inc., Aon, Willis Towers Watson and Brown & Brown Insurance.

Each approach has relative benefits, costs and complexities. There is no "one size fits all" solution—it will depend on each broker's specific facts and circumstances and which factors are most relevant. Some brokers 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.

Marsh Inc.

*The Company elected to apply the **modified retrospective** method to **all contracts**. The comparative financial information included herein has not been restated and continues to be reported under the legacy accounting standards that were in effect for those periods.*

Willis Towers Watson

*We adopted ASC 606 using the **modified retrospective approach**, and elected to apply the following "practical expedients" during adoption:*

*• We elected to apply the new standard only to **contracts that are not completed** as of the transition date. This had the net effect of reducing revenue recognized under ASC 606 due to the change in method in our Health and Benefits broking business*

• We elected to reflect the aggregate effect of all modifications made to contracts prior to the transition date, January 1, 2018, rather than retrospectively restating the contracts for each of these modifications

Aon

*The Company elected to apply the **modified retrospective adoption approach** to **all contracts**. Under this approach, prior periods were not restated. Rather, revenues and other disclosures for prior periods were provided in the notes to the financial statements as previously reported under ASC 605, and the cumulative effect of initially applying the guidance was recognized as an adjustment to retained earnings.*

Brown & Brown Insurance

*The Company adopted these standards by recognizing the cumulative effect as an adjustment to opening retained earnings at January 1, 2018, under the **modified retrospective method** for **contracts not completed** as of the day of adoption.*

Conclusion

The adoption of ASC 606 will be complex and likely will require significant hours to correctly implement. The effect on each insurance broker will vary depending on existing revenue streams and estimation methodologies. Even if the amount or timing of revenue recognition does not change, presentation and disclosure will. In addition, companies will have to redraft accounting policies under the new principles and update internal controls for the increases in management's judgments. BKD has prepared a library of **BKD Thoughtware®** on revenue recognition issues. Visit our website to learn more. If you have questions about this standard, contact your BKD advisor.

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