

# Changes to revenue recognition impacting insurance entities

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January 2020

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## A. Introduction and background

In May 2014, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board issued substantially converged final standards on revenue recognition. These final standards are the culmination of a joint project between the Boards that spanned many years. FASB Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers (Topic 606)*, provides a robust framework for addressing revenue recognition issues and replaces almost all pre-existing revenue recognition guidance in current U.S. generally accepted accounting principles (GAAP) (i.e., legacy GAAP), including industry-specific guidance and SEC Staff Accounting Bulletin Topic 13 (which is also part of legacy GAAP for public entities and generally was followed by private companies).

Implementation of the robust framework provided by ASU 2014-09 will result in improved comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. For public business entities (PBEs) and certain not-for-profit entities, implementation was required no later than annual reporting periods beginning after December 15, 2017, and the interim periods therein. However, if an entity is a PBE solely because its financial statements or financial information is included in a filing with the SEC pursuant to certain SEC rules and regulations (e.g., an acquired private company when its financial statements must be included in the acquirer's filing with the SEC), it may choose to adopt the new guidance in accordance with either (a) the effective date otherwise applicable to PBEs or (b) the effective date applicable to private companies, which is annual reporting periods beginning after December 15, 2018, and interim periods thereafter.

The FASB has amended the guidance originally included in ASU 2014-09 several times since its issuance. The new guidance primarily is included within the following sections of the FASB's Accounting Standards Codification (ASC):

- Topic 606, "Revenue from Contracts with Customers"
- Subtopic 340-40, "Other Assets and Deferred Costs – Contracts with Customers"

For a detailed discussion of the new guidance (as amended), refer to [A guide to revenue recognition](#). Additional information is available in our [Revenue Recognition Resource Center](#).

In addition, the American Institute of Certified Public Accountants (AICPA) has organized several industry-specific task forces, including one focused on insurance entities. The culmination of the AICPA task forces' activities was the issuance in 2019 of a final comprehensive nonauthoritative revenue recognition audit and accounting guide (the Revenue Recognition AAG) that provides helpful discussion and illustrative examples on how to apply the new guidance. Additional information about the Revenue Recognition AAG can be found on its [website](#).

## B. Scope

While ASU 2014-09 replaces most existing industry-specific revenue recognition guidance, it does not replace the guidance applicable to insurance entities in ASC 944, *Financial Services—Insurance*. Accordingly, most insurance contracts entered into by risk-bearing insurance entities are scoped out of the new guidance, similar to the treatment under legacy GAAP. This exclusion applies to all contracts within the scope of ASC 944 such as life and health insurance, property and liability insurance, title insurance, and mortgage guarantee insurance. However, as noted in paragraph BC14 of ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers*, the scope exception does not apply to contracts of insurance entities with customers that are outside the scope of ASC 944. For example, a contract for administrative services (such as claims processing) without any insurance element would be accounted for under ASC 606.

Entities also should consider whether contracts are only partially within the scope of ASC 944. ASC 606-10-15-4 requires an insurance entity to bifurcate contracts into elements within the scope of ASC 944 and elements within the scope of ASC 606.

When considering costs to fulfill an insurance contract, costs that relate to activities within the scope of ASC 944, such as insurance risk mitigation or cost containment activities, continue to be accounted for in accordance with ASC 944. Paragraph 14.7.10 of the Revenue Recognition AAG notes that the following costs generally should be considered fulfillment activities (that either mitigate risks to the insurer or contain costs related to services to fulfill the insurer's obligation) not within the scope of ASC 606:

- Claims adjudication and processing
- Additional activities related to the fulfillment of health insurance contracts, including enrollment, provider network access, routine physicals and screenings, immunizations, preventative care, wellness benefits, etc.
- Safety inspections
- Roadside assistance provided with an automobile insurance policy
- Cybersecurity activities
- A title search provided with a title insurance policy

Finally, the revenue guidance previously applied by non-risk-bearing entities in the insurance sector (e.g., third-party administrators, agents, brokers) will be superseded. Application of the new guidance by these entities could significantly affect the timing and amount of revenue recognized, depending on their business models and previous accounting policies.

### C. New five-step revenue recognition model

The new guidance includes the following five-step revenue recognition model:



An overview of each step is provided in this section of the white paper. For a comprehensive discussion of the five-step revenue recognition model and other aspects of the new guidance, refer to [A guide to revenue recognition](#).

#### C.1. Step 1 - Identify the contract with a customer

A contract is defined in ASC 606-10-25-2 as “an agreement between two or more parties that creates enforceable rights and obligations.” To account for a contract in accordance with ASC 606, the following five criteria (the contract existence criteria) must be met:

- Commercial substance exists
- Approvals have been obtained and a commitment to perform exists on the part of both parties
- Rights of both parties are identifiable

- Payment terms are identifiable
- Collection of substantially all of the amount to which the entity will be entitled in exchange for the goods or services that will be transferred to the customer is probable (i.e., likely to occur) (the collectibility criterion)

When all of the contract existence criteria are met, the remaining steps in the five-step revenue recognition model are applied to the contract.

### **C.2. Step 2 - Identify the performance obligations in the contract**

Identifying the performance obligations in the contract establishes the units of account to which the transaction price should be allocated and for which revenue is recognized. There are generally two steps an entity must perform when identifying the units of account in a customer contract:

- *Identifying all of the promises to provide goods or services.* The multiple-element arrangement model in legacy GAAP provided very little guidance with respect to what constitutes an element or deliverable (e.g., a promised good or service). Conversely, detailed guidance on identifying all of the promised goods or services in a customer contract is provided in the new guidance.
- *Determining whether the promised goods or services that will be transferred should be accounted for separately.* Under the general multiple-element arrangement model in legacy GAAP, a delivered good or service must have standalone value to the customer to be accounted for separately. Under the new guidance, a promised good or service is distinct and accounted for separately if it is both (a) capable of being distinct and (b) distinct within the context of the contract (i.e., separately identifiable from the other promised goods or services in the contract).

These differences in how the units of account are identified in a customer contract could lead to changes in the timing and amount of revenue recognized. As a result, entities must carefully evaluate the terms of their customer contracts to determine whether the goods and services provided under the contract represent one or more performance obligation(s) that should be accounted for separately under the new guidance.

### **C.3. Step 3 - Determine the transaction price**

Under the new guidance, the transaction price (and, ultimately, the amount of revenue recognized) should reflect the amount to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, which includes variable consideration (e.g., performance bonuses, penalties and contingent payments). However, there is a constraint on the variable consideration included in the transaction price that limits it to the amount for which it is probable that a significant reversal in cumulative revenue recognized will not occur. This approach to variable consideration may accelerate the timing of revenue recognition compared to legacy GAAP.

### **C.4. Step 4 - Allocate the transaction price to the performance obligations**

If a contract has more than one performance obligation, the transaction price generally should be allocated to each performance obligation based on the standalone selling prices of each performance obligation in relation to the total of those standalone selling prices (i.e., on a relative standalone selling price basis). Exceptions are provided for certain situations involving discounts and (or) variable consideration that can be shown to be related to one or more (but less than all) performance obligations.

Under the new guidance, the residual method may be used to estimate the standalone selling price of a performance obligation under certain circumstances. This differs from the general multiple-element arrangement model in legacy GAAP used by non-risk bearing entities, which does not permit use of residual methods. Depending on a non-risk bearing entity's product offerings, delivery model and current revenue recognition accounting policy, this change could affect when the entity recognizes revenue and (or) the amount recognized.

### **C.5. Step 5 - Recognize revenue when (or as) each performance obligation is satisfied**

Under the new guidance, a determination must be made regarding whether a performance obligation is satisfied at a point in time (in which case revenue is recognized at the point in time control of the underlying goods or services is transferred to the customer) or over time (in which case revenue is recognized over time as control of the underlying goods or services is transferred to the customer). At least one of the following criteria must be met to conclude that a performance obligation is satisfied over time:

- The customer simultaneously receives and consumes benefits as the entity performs.
- Control of the promised goods or services transfers to the customer as the entity performs.
- The asset created by the entity's performance does not have an alternative use to the entity, and the entity's right to payment for its performance to date is enforceable.

If none of the criteria are met, revenue is recognized at a point in time.

In addition to determining whether a performance obligation is satisfied (and revenue is recognized) at a point in time or over time, detailed guidance is provided with respect to identifying (a) the point in time control of a good or service transfers to the customer and (b) the manner or pattern in which control of a good or service transfers to a customer over time.

### **D. Contract costs**

Under the new guidance, unless the practical expedient can be and is elected, entities must capitalize certain costs of obtaining a customer contract if certain criteria are met. This is different than the prior practice of expensing costs to obtain a customer contract as they are incurred in many cases. ASC 340-40 addresses the circumstances under which certain costs that arise in conjunction with performing under contracts within the scope of ASC 606 should be capitalized. The two categories of costs addressed in ASC 340-40 are costs to fulfill a contract and costs to obtain a contract.

### **E. Disclosure requirements**

The new guidance includes many new qualitative and quantitative disclosure requirements. The objective of the disclosure requirements is to help financial statement users understand the nature, amount, timing and uncertainty of revenue and related cash flows. In general, entities are required to disclose a variety of information about the contracts they have with customers and significant judgments used in the application of the new guidance. While the most disclosures are required of public entities, many disclosures also are required of nonpublic entities.

An entity should review its systems, processes, procedures and controls to determine whether it is capable of providing the information necessary to satisfy the new disclosure requirements, and if not, what changes it must make to enable it to provide the necessary information.

### **F. Conclusion**

While most risk-bearing insurance entities' contracts are scoped out of the new guidance, similar to the treatment under legacy GAAP, the revenue recognition policies of all non-risk bearing entities (and risk-bearing entities for non-risk bearing activities) in the insurance sector will be affected by the new guidance. The degree to which a particular non-risk bearing insurance entity's revenue will be affected depends on its facts and circumstances. However, every non-risk bearing insurance entity will be significantly affected by the disclosure requirements in the new guidance because they substantially increase the volume of revenue-related information disclosed in the financial statements. The new guidance will require these entities to evaluate whether any changes are needed to their current revenue and financial reporting processes and systems to comply with the new guidance. This will undoubtedly

require substantive involvement by more than just those involved in the accounting function. To discuss the impact of the new guidance on your company and its financial statements, don't hesitate to contact your RSM representative or Jim Greisch (+1 402 344 6104).

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