ReaganView

Revenue Recognition Changes

To our Clients and Friends:

The mandatory implementation date of FASB's new Revenue Recognition Standard (ASC 606) was 1/1/18 for public companies, and its 1/1/19 effective date for private companies is lurking just around the corner. "Lurking?" you ask? Well, yes, if it impacts your firm. We will address these questions:

- **What is it?**
- **Who does it impact in our industry?**
- **If our firm is impacted, what should we do?**
- **What is its impact – revenues only, or expenses also?**
- **Is there a simple solution?**
- **Why did they do this to us?**

What is it?

In 2014, FASB and IASB (International Accounting Standards Board) issued a converged standard, ASC 606 Revenue from Contracts With Customers. As stated, "The core principle of this Topic is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

Who does it impact in our industry, and what is its impact? First, it has a sweeping impact across all industries and entities (public, private and not-for-profit) that

1. enter into contracts with customers (in writing, orally, or in accordance with other customary business practices)
2. have GAAP financials (reviewed or audited), including those firms that may need to confirm that they have GAAP financials such as for loan covenants or in future

As a result, many insurance agency/brokerage firms are impacted. The Public Brokers implemented the change in their 2018 Q1 reporting, and private firms are required to implement it for their 2019 reporting (for reporting periods beginning >=12/15/18).

If our firm is impacted, what should we do?

One of the most important things to know is that implementation requires a retrospective recasting of the Equity balances forward on your 2019 Balance Sheet. That means that you and your accountants must figure this out and calculate it as of 12/31/18. (Yes, that is within the next 4 months.) Beyond that, your financials (published) will have to incorporate these new revenue and expense recognition requirements.

What is its impact – revenues only, or expenses also?

The change includes revenues and specific expenses, identified as Costs to Acquire and Costs to Fulfill. Simply stated, then, the impact to our industry is that revenues will be recognized when "earned." Depending on the type of insurance/service provided, revenue recognition may be at policy effective date or over the policy term (based on specific patterns) or even beyond, and corresponding expenses will be "capitalized" (recognized/accrued/deferred). Interpretations varied within the Public Brokers, and there are variations within how the large private brokers anticipate doing it, but here's an overview of its likely implementation (which will be firm-specific).

Income:

1. P&C (Commercial and Personal) – recognize/accrue at policy effective date
2. Contingents – recognize/accrue in the year earned (over the course of the year, on a conservative basis) versus in the year received [Ex: accrue contingents earned in/based on 2019 results, even though $ will be received in 2020]
3. Benefits – many firms plan to recognize over the policy term

Expenses (using "practical expedients" as allowed by ASC 606):

1. Costs to Obtain – capitalize (an asset) and amortize the expense based on your firm's fact pattern [Ex: producer commission compensation]
2. Costs to Fulfill – capitalize (a liability) and amortize based on your firm's fact pattern [Ex: servicing costs]

Interestingly, once the 12/31/18 Equity impact has been retrospectively reflected on your 2019 Balance Sheet, there will not be significant impact to your annual Income Statements. For any rolling 12-month period, you will have recognized a) the annual commission/fee income, and b) the annual expenses incurred for each policy placed or service provided. The commissions/fees will reflect your organic growth, but that can be estimated using easier methods. For many firms, though, one of the significant impacts will be the resulting acceleration of net income and income taxes - for accrued revenues (AB & DB installment commissions and contingents) less certain expenses.

We hope so! Although it doesn't exactly qualify as "simple," there is a potential solution that will make implementation doable and without a major overhaul of your automation system and/or doubling your accounting staff. We have been working with some of our clients, one of the automation vendors, and a large carrier (then, hopefully, others) to develop a system of reports and processes for calculating the commission/fee income "in the pipeline." That information is already available for agency-billed ("AB") policies, but direct-bill ("DB") is the real challenge. The other challenge will be projecting contingents and determining how they should be appropriately recognized in the year earned. Stay tuned!

Why did they do this to us?

Unfortunately, this is the big question for which no one seems to have an answer. As evidenced in the significant variances in the ways the public brokers implemented it (and even within individual Big Four accounting firms), there will continue to be inconsistencies from one firm's financials to another's. Income Statements will still reflect one year's income (as they always have), but there will be amounts in Equity that resulted from myriad calculations and firm-specific interpretations.

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