RECAP • September 21, 2016 • Conference Call

The CFO Working Group met by telephone conference call on September 21, 2016. Council CFO, Ce Harrison, led the call with 31 attendees from 25 member firms. The major topics covered were legislative updates, compliance with FASB's Revenue Recognition and Capital Lease pronouncements, premium rate trends for 2017 and budgeting and forecasting software in use by members.

The Council's Senior Vice President of Government Affairs, Joel Wood, gave the group a legislative update that included the following major items, including basic implications of Presidential and Congressional races:

- Because of so much national uncertainty with the elections and so many downstream implications in the races for the Senate and the House, there has been a high amount of fundraising activity. The Council expects it will be the #1 Political Action Committee in the insurance industry among all 70 insurance trade organizations that have representation in DC, with over $1.2 million raised in 2016.
- Big Issues:
  - Cyber Insurance
  - Congress protecting clients from the multiple battles that have been going on throughout the past 16 years over the extension of the Terrorism Risk Insurance Act.
  - Healthcare Reform. With open season coming up there are major concerns and existential threats to state-based exchanges. Health carriers expressed major concerns that in the absence of the federal reinsurance payments to compensate for the adverse selection that comes into these state-based exchanges Congress has repealed, how much certainty is there for continuation and healthy participation of carriers in those exchanges? While Council member firms generally have little-to-no interaction with the state and federal exchanges or the individual insurance marketplace, there are multiple implications on employer-sponsored coverage irrespective of election results. Preservation of the employer-sponsored model, particularly with respect to the taxation exclusion for employee contributions to plans, is the top concern of The Council. The tax exclusion faces pressures from both the right and the left, and it will require a significant political effort to preserve in 2017.
  - Flood insurance – Authorization for the National Flood Insurance Program (NFIP) is set to expire in September 2017, and legislators are already preparing for a battle over the appropriate role of the federal government in providing coverage in flood zones. Conservatives generally oppose the program and support privatization given the $21 billion debt of the NFIP. Coastal Members of Congress strongly support preservation of the program. Industry representatives are divided on the extent to which "actuarial soundness" can be achieved in the NFIP. The Council's top priority on flood insurance is the enactment of provisions that would encourage the private marketplace for flood coverage, particularly with respect to opening the market up to surplus lines carriers.

- The Council is also involved in all major issues associated with international negotiations on capital standards and all of the broader concerns associated with the historic divide in the state versus federal camp, the engagement of the federal insurance office and representing our interests on the international front.
  - 2 prominent representatives, Republican Rep. Ed Royce (Chairman of Foreign Relations Committee) and Democratic Rep. John Larson (ranking member of the House Ways and Means Committee) are going to introduce legislation that would carve us out from FATCA. This Act is one of the most frustrating over the past few years because it imposes requirements on the commercial brokerage industry. It is The Council's deeply-held belief that international commercial property casualty insurance products are not a vehicle for U.S. income tax evasion, and they should not be included in this legislation. Ultimately, it is going to amount to hundreds of millions of dollars in completely useless, burdensome regulatory requirements and red tape on our member firms with zero benefit to the federal government.
  - Compliance has been very difficult in the year and a half that enforcement has kicked in, and in 2017 it is going to become exponentially more difficult when the foreign-to-foreign aspects of FATCA kick in. Right now, firms must certify in every international commercial property transaction that that carrier is in compliance with this act, and on January 1, firms will have to certify that everyone they do business with is in compliance with that Act. This represents scores of layers of primary and reinsurance that exist in international transactions.
  - The Council has spent the last nine months negotiating with the Joint Committee on Taxation to make sure they fully understand what we are intending to do and to get them to the position where this legislation is going to be viewed as a revenue-neutral one, meaning it will not cost the federal government anything in terms of revenue to release us from this burdensome act.

Members had the following questions for Joel:

- On Amendment 69 in Colorado, what would bring about a single payer health care system? Joel told the group that poll numbers indicated the Amendment was not going to pass. He said that if passed, the Amendment would cost between $25-27 billion, and because Workers' Compensation was part of this amendment, he felt that provider networks would not be able to survive implementation of the amendment. (Subsequently, the Amendment was defeated by an 80-20 margin.)
- If things change with FATCA, what are the technical implications of the changes on our CFOs? Joel stated that CFOs should plan for no changes to the Act before 2017. He said that in the next few weeks he had meetings scheduled with more than 20 Members of Congress and that his only talking point would be to get their names on the bill, as it will not cost the government anything in terms of revenue. He said that on the other hand, it is always far more difficult to get something passed. He also reported that the Deputy Treasury Secretary for International Taxation agrees that insurance brokers should not be included in FATCA; however, there is a view that if brokers get their exemption from FATCA requirements, other financial services sectors would seek changes as well. If the FATCA provisions are to be upended, it will probably be in the context of broad tax reform in the first half of 2017.

Next, Evan Bogardus, partner from Ernst & Young and presenter at The Council's 2016 CFO and Finance Manager's Conference, spoke to the group to continue the discussion on the requirements of the two FASB pronouncements, Revenue Recognition and Leas accounting. He discussed how CFOs should respond to those changes, how revenue recognition applies to the industry and how to budget and forecast for revenue based on the pronouncement.

Evan has worked with firms on compliance with the revenue standard and told the group the following:

- Some companies are getting to a point where they have done the inventory analysis to answer basic questions about the different types of contracts that exist and what the different types of revenue streams are to identify what population might be affected by the pronouncement, before determining the key implications of running through the five-step recognition guideline of the pronouncement.
- One large issue is with the costs of contracts and whether certain fulfillments of acquisition costs can be capitalized.
- Questions from the group:

1. Are there any coverages or specific contract types in insurance that you feel would not be eligible to take the income from?

  - In the majority of cases, where the activity is primarily placement, there may still be certain types of contracts that are revenue-deferred. For example: things that are highly complicated, like large claim-type contracts, where the service provided by the broker helps the policyholder negotiate final claims. There are arguments as to whether that is simply good customer service leading to the next contract or if that is a performance obligation that was part of the last contract. Where there are coverages that have potentially large and complicated claims and a broker or an agent assists with the policy, that would indicate a potential deferral of revenue.
  - Another common example is an asbestos-mesothelioma type policy, where there is a workers' compensation policy or an employee liability policy that many years later, policyholders are still waiting to get their claims back from insurance companies related to those coverages. Often times you see brokers assisting with the settlement of those claims and that would also likely indicate the need to defer revenue.
  - Potentially, wherever your firm is providing a service for a fee or a fee for service activities, CFOs should understand how those services are being earned based on the service performed up front or over the period that the contract is in place. Conversely, a commission paid in installments solely for placement services may be accelerated if currently recorded on a cash basis.

- Evan indicated that there may be less focus on the size of the claim and more on the complexity. If you have a policyholder who is genuinely not sophisticated enough to be able to manage their own claims with the insurance company, or if it is just common practice, that would be a place to look if there are other performance obligations that we contractually take on through common business practice.

- Evan gave a very simplified example where a broker might enter into a contract where there are several deliverables for which the fee is apportioned based on performance of the deliverables. If any one of those deliverables has a bonus component based on performance, the bonus portion of the revenue will be subject to the standard of variable compensation (not reportable until probable that earned amounts will not reverse) but the rest of the revenue should be reported as earned. It is therefore probable and likely that many contracts can cause CFOs to have several different patterns of revenue recognition.

    - Evan indicated that making the determination of whether and when to accrue revenue is a very judgmental process and that CFOs should look to historical experience. He said that for the calendar year, the overarching concern through August and September is the constant possibility that the entire profit commission could be wiped out. **Once to October or November, there is possibly not as high of a hurdle to determining that it is probable it won't get reversed and therefore may need for the accrual before cash is actually received.**
    - Scenario 1: We sell a policy. We tell the client if they ever need help between now and next year, we are always available, but since writing the policy we have not made any specific promises of performance and have historically not done so. In that scenario with the placement of the policy, you have completed substantially all your performance obligations and would recognize the revenue.
    - Scenario 2: We sell a policy and the revenue is commission from that policy. We tell the client we are going to do certain things for them and are not charging a fee, but it is still related to the promise we are making to the client. A proportion of revenue might be deferred to reflect these other services.
    - Scenario 3: Even though we intend to place the policy, we are no longer going to take commissions. We are going to charge a fee to the client, and that fee is going to be specific to services that we are going to outline. Revenue is recognized as those services are performed.

2. Is there a place where you have to defer the revenue of the services because you are going to be performing services that the client is technically not paying for?

- You can either look at the service you are providing in the intermediate scenarios between different placements as "Sales Activity" and "Pre-placement Marketing", or you could look at it as something you are doing as a result of someone placing the policy.
- If you had no intention or no expectation of ever getting a renewal out of it if you wouldn't provide that service, you're probably in a better position of saying you wouldn't defer the revenue. But it is judgmental in terms of deciding whether it is marketing for the renewal versus something you have committed to doing.

3. Does it help if the contract indicates the fee is earned entirely up front at the placement of the policy?

- If legitimate additional services are going to be performed, then it would still have to at least be considered for deferral. If the reality is that it only takes you two hours to do it from a

materiality perspective, then perhaps a materiality argument might be valid. Any expectations of cancellations or non-payments need to be appropriated into the amount that is earned as well.

4. **If so much of the application of the pronouncement is based on judgment and historical practice, who is to say this is a wrong judgment?**

   - It is ultimately up to management to determine that, and then up to the auditor to agree, disagree or challenge. As long as you write down what you believe and have evidence of why you believe it, you are in a good position to go to your auditor and present that. Always document how and why you did what you did.

5. **How do you deal with changes in number of employees insured at the client?**

   a. Principle-based answer: 80-90% effort is done with negotiating a case.
   b. To the extent that you anticipate the employee head count will go down, you will have to anticipate upfront for commission revenue off the employee base.
   c. To the extent that it goes up beyond the 12-month contract, you would have to discount the rate it back to its present value.
   d. Moving parts: additional services, number of employees covered (hit a minimum number and do the rest around a cash/accrual basis).

Evan then went on to briefly discuss the FASBs new guidance on accounting for leases. He made the following points:

- From a lessee perspective, anything today that is considered an operating lease may still be called an operating lease in the future, but an asset and a liability are going to have to be put up on the balance sheet, effectively grossing up the balance sheet for a right-of-use asset and a lease liability.
- At day zero, an operating lease and a capital lease are effectively the same in terms of the present value of the future payments. The liability side is essentially equal to the right-of-use asset.
- Over time, the right-of-use asset will depreciate as it is used. The lease liability is similar to a mortgage where you have accrued interest: make a payment until the final payment is made or until the leased asset is returned.
- There are many nuances with lease accounting. The lease standard is not just for explicit leases but also includes implicit leases that refer to agreements that could contain a lease. For operating leases, you just have the balance sheet, and for capital leases, the accounting is not that different than it is from today.
- Specific words: The contract contains the right to control the use of the identified property for a period of time in exchange for consideration.
  - The more circumstances you can accumulate to refute the idea that you control the use of those assets, the more likely you will be able to justify it is part of their service as opposed to having to separate a lease.

- If Company A enters into a contract with Company B and Company A has limited, if any, evidence that they control the use of some related assets, then you would not separate that out as a lease.
- Refer to Slide 57 in in Evan's Miami presentation – the decision tree.
- If you are not getting substantially all of the benefits, or you do not have the right to direct how to use the asset, then that indicates it is not a lease.

The group then discussed premium rate trends for 2017 and how CFOs were going about predictions for budgeting for premium rates. One member said that for the history of the rate structure, they are looking at specific areas region by region, and they are not predicting a hardening of the market. Members, for the most part, indicated they will lean more toward a softening of the market.

Group members then discussed what they were using for budgeting and forecasting software, and Craig Stahlberg of Payne West reported he had surveyed several agencies on their preferences and for purchased software, it was evenly divided between Adaptive Insights and ProFix. Many CFOs use their own internally-designed tools including Excel-based reports. Craig reported that he had reviewed six vendors, and Payne West had chosen Pro-Fix because they felt the interface was user-friendly and would be easy for producers and managers to use.

ProFix users in the group indicated the software company has continued to grow and enhance their product and the product handles financial reporting, budgeting and forecasting down to operational levels with open capability.

The decisions about which software tools to use are also driven by whether the firm wants to host their own software or use it in the cloud, and by price, customer service and adaptability of training in various situations. ProFix is primarily a user-hosted product, while Adaptive Insights and Host Analytics are both cloud-based. All of the products discussed had different price levels based on the number of user licenses.

Adaptive Insight users reported that it works very well for them, particularly larger, more complex firms, and the reporting features were excellent. The software has a feature where you can access live data through spreadsheets continuously.

The meeting closed with a short discussion on the CFO Conference for 2017 that will take place in Seattle from June 14 – 16. Ce said that after the first of the year, she would be reaching out to those who volunteered to work on the conference programming. She reminded the group there would not be a CFO Working Group meeting at the Legislative Summit and Joint Working Group meeting in DC February 6 – 9, 2017 so that CFOs and finance managers could take advantage of the opportunity to attend other working groups in where they had an interest. The group will continue to meet in person at the annual conference and by conference call each fall, and members of the working group are strongly encouraged to attend the Legislative Summit for its joint and individual working groups such as the CIO, HR and Marketing & Communications Working Groups.