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ACCOUNTING AND REPORTING GUIDE

FOR

INSURANCE AGENTS AND BROKERS

This guide presents the views of the Insurance Agents and Brokers Tasks Force and is intended to document the present accounting and reporting practices followed by insurance agents and brokers. The guide also sets forth the consensus conclusion of the Task Force with regard to each issue raised.

This guide has not been exposed for comment nor has it been presented to or approved by the AICPA or any other recognized accounting standards setting organization. As such, the advisory conclusions contained herein have no authorized sanction or standing.

Prepared by the
Insurance Agents & Brokers Task Force
of the
Insurance Companies Committee
American Institute of Certified Public Accountants

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INTRODUCTION

1. At present, no authoritative accounting literature specifies generally accepted accounting principles for certain of the specialized transactions of insurance agents and brokers, and the industry has developed diverse accounting and reporting practices in several areas. This guide describes the industry's current accounting and reporting practices and provides conclusions and recommendations on accounting and reporting by insurance agents and brokers.

2. The sections of this guide on "General Background" and "Retail Brokers" address issues primarily as they relate to the operations of property and casualty insurance brokers. However, because of the similarity in operations, those discussions are also relevant to brokers' activities in accident and health insurance, group insurance plans, employee benefits services, and short-duration term life insurance. Subsequent sections of this guide discuss the unique considerations relating to managing general agents, reinsurance brokers and intermediaries, long-duration life insurance brokers, and affiliated brokers, as well as the reporting business combination issues related to the purchase of insurance agencies or brokerage firms.

GENERAL BACKGROUND

3. Insurance agents and brokers function as intermediaries between insureds (i.e., clients) and insurance underwriters, and they distribute a substantial portion of the insurance marketed in the United States. Insurance is also distributed, among other methods, through direct selling by personnel employed by insurance underwriters, mail order sales, contacts through department stores and airports, and direct mass media solicitation.

4. Insurance brokers act on behalf of their clients by developing risk management programs, which can include both the retention of risks by clients (i.e., self-insurance) and the transfer of such risks to underwriters through insurance negotiated and placed by the broker. An insurance agent is an agent of one underwriter (an exclusive agent) or several underwriters (an independent agent) with express or implied authority to act for them in dealing with insureds. The activities of these two kinds of insurance producers and their relationships with the underwriters are often not distinct. A producer may be a broker in one transaction and an agent in the next. While there are legal distinctions between insurance agents and insurance brokers, this guide does not distinguish between the two classifications. Unless otherwise specified, this guide uses the term "broker" to refer to both insurance agents and insurance brokers.

5. Brokers place commercial lines and personal lines of insurance. Commercial lines consist of property and casualty coverages for business enterprises, which include insurance against damage to property, liability indemnity insurance, workers' compensation insurance, and group life and health insurance. Personal lines consist of coverages for individuals, which include primarily of automobile and homeowners or tenants insurance and individual life insurance.

6. Brokers may also place fidelity and surety bonds, develop and administer employee benefit programs and retirement plans, and furnish a

wide variety of advisory and consulting services, such as claims and loss processing assistance, feasibility studies for and management of captive insurance companies, claim reserve analyses, loss control studies, actuarial studies, and the formulation of new kinds of insurance coverage.

7. Brokers include retail brokers, wholesale brokers, reinsurance intermediaries, and managing general agents.

- Retail brokers act as intermediaries between clients seeking insurance coverage and underwriters. Retail brokers include certain financial institutions, such as banks and securities brokers, that also are active in marketing certain kinds of insurance coverages.

- Wholesale brokers act as intermediaries between retail brokers and underwriters. Wholesale brokers include excess and surplus lines brokers and brokers that place insurance in international insurance markets, such as Lloyd's of London.

- Reinsurance intermediaries act as middlemen between underwriters in the transfer of insurance risks.

- Managing general agents act as agents of one or more insurance underwriters in selecting, underwriting, and servicing business for the underwriters represented.

Commission and Fee Arrangements

8. Brokers often are compensated for their services by commissions paid by the underwriters. The services that a broker ordinarily provides in return for commissions include evaluating the risk, determining the insurance requirements, selecting the underwriter, and placing the insurance. The broker may also provide services after the insurance has been placed, such as processing and collecting claim settlements for the client. The commissions usually are stated as a percentage of the

insured's premium, and such commissions are referred to in this guide as "regular commissions." The commission rates vary depending on a number of factors, including the kind of insurance, the amount of the premium, the broker's arrangement with the particular underwriter, and the legal capacity in which the broker acts. Under negotiated commission arrangements, a broker agrees with the client to handle its insurance program for a commission rate different from the standard commission rate.

9. The industry has also developed a compensation arrangement commonly referred to as a "fee in lieu of commission" arrangement. Under such an arrangement, a broker agrees to handle a client's insurance program for an agreed fee, which may be more or less than the amount of regular commissions that the broker would normally receive.

10. Many brokers provide services that do not relate to obtaining insurance coverage and are compensated under agreements for fees for services rendered. Examples of these types of services are underwriting management, loss prevention inspections, risk management consulting, claims management, employee benefit consulting, and administration of self-insurance programs. Such brokers normally are compensated under fee arrangements based on physical events, such as the number of loss prevention inspections made or claims processed, or on a project basis, such as fixed fees or hourly charges for risk management studies or for the management of captive insurance companies. Brokers sometimes agree to receive a single fee for service arrangements, as described in this paragraph, and for the placement of insurance coverages; these arrangements are referred to herein as "bundled transactions."

11. In addition to the regular commissions, negotiated commissions, and fees in lieu of commissions received by brokers for basic services, many brokers also receive contingent commissions from underwriters under various types of profit-sharing arrangements. Subject to the terms of such arrangements with the underwriters, the brokers' ultimate commission generally depends on the profitability of the business placed by the

brokers with the underwriters. The contracts generally provide for contingent commissions to be paid in the first half of the calendar year based on the profitability of the business placed with the underwriters in the preceding three-year period. The amounts of contingent commissions to be received in a given year are rarely determinable by the brokers in time for inclusion in the brokers' financial statements for the periods on which the contingent commissions were based.

12. Shared or split commissions may be used if more than one broker is entitled to a portion of the commission on an insurance policy. The primary broker generally bills and collects the entire premium and commission and remits the share of the commission owed to the participating broker or brokers (the sub-brokers).

13. The broker commonly bills the client, collects the total premium, retains its commission, and remits the net premium amount to the underwriter. Several methods are in use for billing premiums, as follows:

- Brokers sometimes bill the anticipated premium (or some portion thereof) when a binder is issued to expedite collection of the premium. Later, a final invoice is issued when the amount of the premium has been determined, when all of the applicable insurance documents have been received, or when any necessary adjustments to the binder billing have been made. A binder is a temporary insurance contract created to confirm to the client that coverage is in force pending creation of the formal insurance policy. Binders that contain premium billings are called "premium-bearing binders."

- Brokers frequently bill their clients when the broker receives the policy from the underwriter for delivery to the client.

- Brokers sometimes bill their clients on a monthly, quarterly, or semiannual installment basis. Certain kinds of policies occasionally are written on a three-year basis, and annual or more frequent billings are made on these policies.

- On some policies, the clients pay the premiums directly to the underwriters, which pay commissions to the brokers. This direct billing method is used most frequently with personal lines, employee benefit plans, and life insurance coverages.

Advances By Brokers

14. Brokers sometimes advance insurance premiums on behalf of clients to the underwriters before the brokers receive the premiums from the clients, thus putting the brokers at risk for the collection of the premiums from the clients.

15. Brokers sometimes also advance claim settlements or premium refunds on behalf of underwriters to the clients before the brokers receive the settlements or refunds from the underwriters, thereby putting the brokers at risk for the collection of the amounts from the underwriters.

Commission Adjustments

16. A broker's commission may be adjusted when the related premium is adjusted, when coverages under the insurance policy are changed, when the policy is cancelled, when errors have been made in calculating the premium or commission, or when the premium is retrospectively rated or is subject to audit.

17. When the terms of an insurance policy are changed, for example, by adding to coverages, increasing deductibles, or deleting coverages, the documentary evidence of the change is referred to as an endorsement. Endorsements may result in additional premiums, returned premiums, or no premium adjustment.

18. For retrospectively rated policies, premiums vary with the history of the losses during the periods covered by the premiums. A considerable amount of workers' compensation, group accident and health, boiler and machinery, commercial automobile, and general liability insurance

coverages are written on such policies. Retrospective adjustments bring the premiums and the related commissions to their final amounts.

19. For certain kinds of insurance, the insureds' records are audited at the ends of the policy periods, often by the brokers or their representatives, to determine the amounts of premiums to be charged for the periods of coverage. For example, the insureds' payrolls, number of employees, values of properties held, gross receipts, or units sold may be audited during or after the policy periods to ascertain the amounts of premiums that are due for the coverages provided. Additional premiums or return premiums are determined based on these audits.

20. For certain kinds of insurance, variable premiums (referred to as "reporting-form premiums") are charged based on predetermined rates applied to values that change throughout the policy period. In those instances, the premiums generally are calculated, reported, and remitted by the insured to the insurer on a periodic basis, often monthly. Examples of coverages for which reporting-form premiums are common are workers' compensation, general liability, builders' risk, and broad form cargo policies. For these types of coverages, the reporting-form premiums and related commissions generally are not reasonably determinable prior to notification from the insured via the reporting-form mechanism.

21. Brokers' commissions are subject to return in whole or in part if policies are canceled and the related premiums are returned. There are three different kinds of policy cancellations, generally referred to as follows:

- "Flat" cancellations, in which the entire premiums are returned.
- "Pro rata" cancellations, in which proportionate amounts of the premiums related to the unexpired portions of the policy periods are returned.
- "Short rate" cancellations, in which amounts specified in the contracts are returned, which amounts are less than the amounts calculated on a pro rata cancellation basis.

Investment Income

22. Brokers collect premiums from insureds and, after deducting their commissions, remit the balance to the insurance underwriters. Brokers also collect claim settlements or premium refunds from underwriters on behalf of insureds. Until remitted to the underwriters or the insureds, brokers hold those amounts as fiduciaries. These funds generally are invested in short-term cash equivalents, and the investment income earned on these funds is retained by the brokers. Certain states have varying restrictions on the investment of the funds, which include limiting the nature of the acceptable investments, investing the funds within the state, or obtaining permission of the underwriters to retain the investment income. The total investment income that the brokers earn includes investment income on the foregoing funds and on their own funds.

Broker of Record

23. The broker of record, i.e., the broker at the date when the insurance was placed, generally is entitled to retain the related commission income if the client changes brokers during a policy period. Also, brokers of record customarily are not contractually obligated to continue providing services under the policies; however, a broker of record may voluntarily decide to continue to do so.

Foreign Brokerage Operations

24. A number of the larger U.S. based brokers have, for some time, maintained brokerage operations in foreign countries in addition to their operations in the United States. These foreign brokerage operations were often established and maintained to meet the local service requirements of the large multinational clients of the U.S. based brokers. In addition, particularly in the highly-developed local economies, such as in the United Kingdom and Western Europe, these foreign brokerage operations represented efforts by the U.S. based brokers to offer the same services to the foreign business entities and individuals as the

brokers provide in the United States. U.S. based brokers also have acquired foreign brokerage operations to gain direct access to worldwide insurance underwriting markets such as Lloyd's of London.

25. As a consequence of the diverse objectives for which U.S. based brokers have established operations in other countries, such investments have taken various forms, including wholly-owned subsidiaries, branches, joint ventures, and minority interests in local brokers in the foreign countries.

26. The kinds of services offered to clients in foreign markets often are similar to those offered in the domestic market. As a result, the fundamental issues in accounting and financial reporting by U.S. based brokers that are the subject of this guide also generally apply to their foreign operations that are consolidated with the domestic operations or included on an equity basis in their financial reports prepared in conformity with generally accepted accounting principles in the United States. Nevertheless, local customs or business practices, as well as legal requirements and restrictions, often affect the specific issues in each country and need to be considered when financial reports are prepared.

27. In addition to the accounting and financial reporting issues unique to brokers discussed in this guide, all other aspects of accounting for the foreign operations of U.S. based brokers should conform with generally accepted accounting principles in the United States. For example, foreign accounting practices that may need to be modified to conform with U.S. accounting standards could include revenue and expense recognition practices, accounting for income taxes -- particularly deferred taxes, amortization of goodwill, interim reporting, equity accounting, foreign currency translation, and fixed asset valuation. The means of conforming those practices is beyond the scope of this guide.

28. An insurance broker provides services. No specific accounting pronouncements now address revenue recognition for service transactions. FASB Concepts Statement No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," paragraph 84, provides only the following general guidance:

> In recognizing revenues...the two conditions (being realized or realizable and being earned) are usually met by the time...services are rendered to customers.

29. In October 1978, the Financial Accounting Standards Board ("FASB") invited comments on a draft statement of position, "Accounting for Service Transactions" (hereinafter referred to as the "Draft SOP"), which was prepared by a task force of the AICPA's Accounting Standards Executive Committee. The project was later incorporated into the FASB's conceptual framework project, and the conclusions of the Draft SOP have not been issued as an authoritative pronouncement. The AICPA task force summarized its revenue recognition conclusions for service transactions in the Draft SOP as follows:

> Revenue from service transactions should be recognized based on performance, because performance determines the extent to which the earnings process is complete or virtually complete. Performance is the execution of a defined act or acts or occurs with the passage of time. Accordingly, revenue from service transactions should be recognized under one of the following methods:
>
> > Specific performance method - Performance consists of the execution of a single act and revenue should be recognized when that act takes place.
> >
> > Proportional performance method - Performance consists of the execution of more than one act and revenue should be recognized based on the proportionate performance of each act. For example, if the service transaction involves a specified number of similar acts, an equal amount of revenue should be recognized for each act. If the transaction involves a specified number of defined but not similar acts, revenue recognized for each act should be based on the ratio of the seller's direct costs to perform each act to the total estimated direct cost of the transaction. If the transaction

involves an unspecified number of similar acts with a fixed period for performance, revenue should be recognized on the straight-line method over the performance period.

Completed performance method - If services are performed in more than a single act, the proportion of services to be performed in the final act may be so significant in relation to the service transaction taken as a whole that performance cannot be deemed to have taken place until execution of that act. Revenue should be recognized when that act takes place.

Collection method - If there is significant degree of uncertainty surrounding realization of service revenue (for example, many personal services), revenue should not be recognized until collection.

30. Brokers provide diverse kinds of services, many of which do not readily fit into the classification system in the Draft SOP. The broker's performance usually consists of more than a single act, and the acts generally are not similar. While certain acts to be performed may be defined, many are not defined. Though the placement of the policy may constitute the most significant act, it may not be the final act.

Revenue Recognition

31. The two major sources of a broker's revenues for services are commissions and fees. The kinds of services provided by the broker, the kinds of insurance coverage for which the services are provided, and other circumstances may affect the consideration of when revenue should be recognized.

32. Regular, Negotiated, and Split or Shared Commissions. Most regular, negotiated, and split or shared commissions are determined as percentages of the clients' premiums. Historically, practice has varied regarding the methods used to recognize commissions associated with placing insurance risks with underwriters. Some brokers recognized commissions as of the billing date of the related insurance policy. Others recognized commissions as of the effective date of the policy. Still others recognized commissions as of the later of the billing date or the effective date. As used herein, the term "effective date" is used to mean the date from which protection is afforded under an insurance policy, and, with respect to endorsements, the date from which an endorsement to a policy amends the existing insurance coverage.

33. At the effective date, the broker becomes entitled to the commission because the insurance coverage has been placed with the underwriter and the premium is owed by the client. The effective date is more objective than the billing date because the broker may have some discretion in selecting the billing date. If the premium is billed on or before the effective date, the broker's work has been substantially completed and the related costs to produce, market, and place the coverage have been incurred on or before the effective date. As such, the amount of the commission related to the services provided has been determined, the premium is receivable, and the commission has been earned as of that date. If the premium is billed after the effective date, significant

portions of the work generally are performed and the related costs are incurred between the effective date and the billing date. Historically, most of the larger and publicly held brokers have recognized commissions as of the later of the effective date or the billing date.

34. Revenue should not be recognized before the effective date, even if it has been billed before the effective date (advance billings). Revenues to cover selling and other costs incurred should not be accrued before the revenue recognition date (as defined in paragraph 34) because, among other reasons, realization is not assured until a transfer of risk has been effected through the issuance of an insurance policy. Brokers historically have not deferred the recognition of commission revenue to future periods. Although certain costs related to a policy may be incurred after the billing or effective date, those costs typically are incurred at the discretion of the broker to retain or increase business with the client and not because the broker is obligated to service the policy in force.

35. Accordingly, for any given policy, revenue from regular commissions, negotiated commissions, and shared or split commissions should be recognized on the revenue recognition date, which is the date on which all of the following criteria are met:

- Protection is afforded under the insurance policy.
- The premium due under the policy is known or can be reasonably estimated.
- The premium is billable to the client.

36. Contingent Commissions. Historically, most brokers have recognized contingent commissions when received or on notification of the amounts from the underwriters. Generally, there is only a short time period between notification and receipt.

37. Contingent commissions often cannot be reasonably determined or even approximated by the broker until receipt or notification from the

underwriters. The amounts generally are calculated by the underwriters, separately for the business placed by each of the broker's locations with the underwriter's local offices. Contingent commissions typically are based on the profitability of business written during a running three-year period. Indications of profitability during the early stages of a three-year period may be entirely offset by losses during the later stages of the three-year period. For example, contingent commissions relating to 1989 activity will be calculated in 1990, 1991, and 1992, based each year on the cumulative experience for the three previous years. Therefore, to accrue contingent commissions at the end of 1989, estimates would have to be made not only of the underwriting results of 1989, but also of the amount of and the quality of business that will be written and placed with the underwriter over the remainder of the three-year period.

38. Even though FASB Statement No. 5, "Accounting for Contingencies" ("FASB 5"), deals primarily with circumstances involving uncertainty as to the recording of possible losses, paragraph 17 concludes that:

> Contingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization.
>
> Adequate disclosure shall be made of contingencies that might result in gains, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

39. FASB 5 defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. The conditions surrounding contingent commissions are sufficiently uncertain and inherently subjective so as to preclude recognition before receipt or notification based on the criteria in paragraph 8 of FASB 5.

40. In rare cases, contingent commissions may be reasonably estimated by the broker before receipt of cash or notification from the underwriter.

As such, the profits earned on such business placed by a broker over a stated period, from which the contingent commission is computed, could be estimated by the broker from historical trends and from current information received from the underwriter.

41. However, retail brokers typically lack sufficient information concerning the profitability to the underwriter on business placed and the inherent uncertainties in determining the ultimate commissions (principally because of the unknown amount of losses that will be attributable to the insurance placed), so the brokers have no way to reasonably estimate and accrue contingent commissions. Accordingly, unless a broker obtains such information and unless all contingency periods have expired (for example, the running three-year period described in paragraph 37), contingent commissions should be recognized by the broker as operating revenue on the earlier of the receipt of cash or notification from the underwriter of the amount to be received.

42. Under some arrangements, adverse underwriting results attributable to business placed by a broker in future periods could require the broker to return contingent commissions received in earlier periods. Such adjustments should be handled as recommended in paragraph 44 for commission adjustments.

43. <u>Commission Adjustments</u>. Commissions initially recognized by brokers often are changed because of policy cancellations, revisions in coverage, final determinations of premiums billed on binders, retroactive or audit adjustments, or premium adjustments based on volume. Historically, the industry practice has been to record such changes when the events occur.

44. Just as contingent commissions generally can be recognized as revenue only on receipt or notification, it is usually not possible to accurately estimate the amounts of commission adjustments in advance. Therefore, commission adjustments resulting from the type of events referred to in paragraph 43 generally should be recognized when the events occur. However, if policy cancellations and return premiums

can be reasonably estimated in advance, a provision should be made for the expected related commission adjustments when the commissions on this business are initially recognized.

45. Premiums to be paid by insureds on a reporting-form basis, as discussed in paragraph 20, generally are not subject to reasonable estimation. Therefore, the related commissions should be recognized when notification is received from the insured.

46. Installment Billing Arrangements. Generally, insurance premiums are determined and billed annually. However, brokers sometimes bill their clients for annual policies in quarterly or monthly installments. Historically, some brokers have recognized their commissions as each installment was billed to the client; others have recognized the entire amount of the commission when the transaction was initially recorded.

47. Because the revenue recognition method is tied to the performance of the service and is not tied to the cash flow effects of the broker's billing arrangements with its clients, the entire commission should be recognized when the transaction is initially recorded. Furthermore, under APB Opinion No. 10, "Omnibus Opinion--Installment Method of Accounting," the installment method of recognizing sales revenues should be used only if there is "no reasonable basis for estimating the degree of collectibility." The collectibility of installment billings for annual insurance policies ordinarily can be reasonably estimated when these types of transactions are initially recorded.

48. Multi-Year Policies. Certain property coverages occasionally are written under policies that cover a number of years, typically three years. Such a multi-year policy may permit the policyholder to lock-in the premium rate for a period of years and thus be protected from increasing rates during the period. Under multi-year policies, premiums may be billed in one amount or in periodic installments. Historically, some brokers recognized a portion of the commissions on multi-year policies as the periodic premiums were billed. Other brokers recognized

the entire commission in the year in which the policy became effective or when the first installment premium was billed.

49. If the policyholder is not obligated to continue coverage after the first year, a multi-year policy should be viewed as a series of annual or short-term policies rather than as a single policy with installment billings. Though a multi-year policy is written to cover several years, there generally is little assurance that premiums will continue to be received, because, for example, if premium rates fall, the policyholder could discontinue coverage for the subsequent years. Accordingly, the commission revenues on such multi-year policies should be recognized as revenue annually when the policyholder pays the annual installment and continues coverage.

50. If, under a multi-year policy, the policyholder is obligated to continue coverage for the entire policy period, the policy is a single policy covering all the years and the periodic premiums should be viewed as installment billings. Because the broker's method of revenue recognition is tied to the performance of the service and is not tied to the cash flow effects of a broker's billing arrangements with its client, the entire commission for the multi-year period should be recognized when the transaction is initially recorded.

51. Direct Billing Arrangements. Brokers generally bill their clients for the gross premium, retain their commission, and remit the net premium amount to the underwriter. However, the underwriter sometimes bills the clients directly or the brokers bill the clients but the clients remit the gross premium payments directly to the underwriter. These arrangements, commonly referred to as "direct bill" transactions, often pertain to personal lines coverages and to life, health, property, and liability insurance distributed through associations and other mass marketing channels. Because the gross premiums from the clients are remitted directly to the underwriters, the broker receives its commissions directly from the underwriter. Historically, brokers

generally have recognized such commissions as revenue on the earlier of the receipt of cash or notification from the underwriter of the amount to be received.

52. If it is possible to reasonably estimate the amount of commissions that have been earned, the commissions attributable to direct bill business should be accrued. However, because the percentage of persons solicited that will purchase insurance coverage and the amount of insurance they will purchase is difficult to project, it usually is not possible for the broker to reasonably estimate the commissions from such business. In such cases, commissions on those types of direct bill transactions should continue to be recognized as revenue on the earlier of the receipt of cash or notification from the underwriter of the amount to be received.

53. Fee in Lieu of Commissions. Rather than receiving commissions from an underwriter, a broker may agree to handle a client's insurance program for a "fee in lieu of commissions" to be paid to the broker by the client. Historically, some brokers have treated these transactions similarly to the way that they have treated "fee-for-service arrangements" and have recognized revenues over the policy period; other brokers have recorded these fees in the same manner as they recognized their regular commissions.

54. Accepting a fee for an insurance placement transaction does not change the nature of the transaction, and, accordingly, those fee revenues should be recognized in the same manner as regular commissions, as described in paragraph 35.

55. Fee-for-Service Agreements. For services, other than insurance placement services, provided under a fee-for-service agreement, as described in paragraph 10, brokers generally have recognized revenue as the services were provided. Fees received for bundled transactions, which are also described in paragraph 10, often have been allocated between insurance placement revenue and service agreement revenue, using

recognition methods appropriate to each revenue component. There is general agreement that this method is appropriate for recognizing revenue on these types of fee-for-service transactions.

56. Therefore, fees for non-insurance placement service agreements, as described in paragraph 10, should be recognized as earned, which is ordinarily over the period in which the services are provided. For bundled transactions, reasonable and consistent allocations should be made between the revenue components, and the revenue should be recognized in accordance with paragraph 35 and the first sentence of this paragraph. A loss should be recognized currently if it is probable that the future costs related to the service agreement will exceed future revenues.

Expense Recognition

57. Brokers incur a variety of costs to generate revenues. As a service business, the industry incurs costs that are predominantly payroll and payroll-related and costs for travel and entertainment, rent, and other general and administrative activities. Services performed by a broker and their related costs can vary considerably depending on the kind and size of the risk to be insured, the nature of the insurance program and the coverages required, and whether the business is new or renewal business. For purposes of analysis, a broker's costs can be classified as initial direct costs, subsequent servicing costs, and indirect costs.

58. Initial Direct Costs. A substantial portion of brokers' costs are incurred before the dates that the policy periods begin and are directly associated with negotiating and placing or renewing the insurance coverage. These initial direct costs relate to brokers' analysis and evaluation of risks and marketing efforts to place or renew the policies.

59. Risk analysis and evaluation can range from a relatively simple study of employee bonding risks to major undertakings to analyze and evaluate the complex worldwide risks borne by multinational clients.

This type of risk analysis and evaluation often results in the preparation of formal proposals or recommendations by the brokers to the clients or prospective clients.

60. Marketing consists of placing the risks with the underwriters in the worldwide insurance underwriting market that can best meet the needs of the client. The marketing process requires the evaluation of the underwriters' capacities, specialties, costs, and other factors.

61. Initial direct costs do not include prospecting costs associated with efforts to obtain new or renewal business from existing clients or business from potential new clients, even though prospecting costs may be incurred for risk analysis and evaluation and marketing efforts similar to those for the renewal of existing insurance policies. Such prospecting costs are indirect costs, as discussed in paragraph 63, not initial direct costs.

62. Subsequent Servicing Costs. A broker may also incur costs for providing services after the effective date of the insurance policy. These costs, referred to herein as "subsequent servicing costs," are directly associated with insurance coverage that has been placed by the broker and relate to, among other matters, services such as billing, collecting, and remitting premiums, performing periodic engineering inspections of the clients' facilities, handling and processing claims reported by the clients, reviewing the adequacy of existing coverage, and monitoring changes in risk exposure. In certain instances, the broker may be obligated to provide such services by contract or agreement. However, the broker usually provides these types of services, at its discretion, to maintain client relationships, even though not contractually obligated to do so.

63. Indirect Costs. All costs incurred by brokers other than initial direct costs and subsequent servicing costs are indirect costs. Indirect costs include primarily payroll and payroll-related costs, travel and entertainment, rent, data processing, and other selling and general

administrative costs. Indirect costs also include prospecting costs associated with efforts to obtain new or renewal business from existing and prospective clients.

64. Recognition of Costs. Historically, brokers generally have treated all costs incurred in providing their services as period costs and, accordingly, have expensed them as incurred. The industry generally has not accumulated or analyzed the costs of its services by function or by insurance policy nor has it allocated costs between prospecting and servicing.

65. The consumption of the economic benefits during a period is measured either directly or by relating it to revenues recognized during the period. Recognizing a broker's costs and expenses as incurred matches the costs required to generate revenues on a period-by-period basis. FASB Concepts Statement No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises," paragraph 85, states that, in general, expenses are recognized when an entity's economic benefits are used up in rendering services.

66. Historically, brokers have not deferred initial direct costs. Because the recoverability of such costs from future revenues is not assured until the coverage is placed and billable to the client, all initial direct costs and indirect costs should continue to be treated as period costs and expensed as incurred.

67. Brokers typically are not obligated, either by contract or by industry practice, to provide services subsequent to placing the insurance. However, brokers generally do provide various services after placement of the coverage so as to retain or increase business with the clients but not because they are required to service the policies; accordingly, these subsequent servicing costs should be expensed as incurred as period costs. However, if a broker specifically obligates itself by agreement with the client to provide services after placing the coverage, and the subsequent costs can be associated directly with the

policy placed by the broker, a portion of the broker's related revenue should be deferred (or costs should be accrued if such costs exceed deferrable revenues) and recognized as the services are performed.

Financial Statement Presentation

68. Brokers usually bill their clients for placing insurance, and the clients pay the brokers. Thus, at the revenue recognition date for a given policy, a receivable and a payable are recorded in the broker's accounting records. The receivable due from the client represents the premium that the broker will later pay to the underwriter plus the commission or fee for the services provided by the broker. The payable to the underwriter is due either on or after the effective date of the insurance policy (an agency transaction) or at or after collection by the broker (a broker transaction). As described in paragraphs 14 and 15, brokers may advance premiums to the underwriters on behalf of their clients or may advance claim payments or return premiums to clients on behalf of the underwriters. The advances may be made because of the payment terms to the underwriter or because the brokers wish to avoid cancellation of their clients' coverages.

69. Because brokers generally collect cash from clients before they pay the underwriters, brokers generally have favorable cash flows. Until remitted to the underwriters, these funds are held by the brokers in a fiduciary capacity for the underwriters. Such funds (referred to herein as fiduciary funds) generally are invested in short-term cash equivalents, and the resulting investment income is retained by the brokers. Certain states have varying restrictions on the investment of such funds, which may include limiting the nature of acceptable investments, investing the funds within the state, or obtaining permission of the underwriters to retain the investment income. Brokers also earn investment income on their own funds.

70. Historically, publicly reporting brokers have used two different methods to present their balance sheets. Under one method, often

referred to as the gross method, accounts receivable have included the total amount of premiums, including commissions and fees, due from clients, and the payables to underwriters have included the total amount of collected and uncollected premiums to be remitted to underwriters. Under this method, the amounts of premiums included in both accounts receivable from the clients and accounts payable to underwriters are usually disclosed in the financial statements. Also, under the gross method, fiduciary funds are included in the cash or other appropriate caption on the balance sheet, and the amount and the related restrictions on the use of such funds are disclosed in the notes to the financial statements.

71. Under the other method, commonly referred to as the net method, only the total amount of commissions and fees due from clients is included in the accounts receivable from clients. The amounts receivable from clients and the payable to underwriters related to uncollected premiums are not presented on the balance sheets but typically are disclosed in the notes to the financial statements. Under the net method, fiduciary funds are not included in the assets on the balance sheet but are separately disclosed, either in the notes or on a memo basis on the balance sheet.

72. The gross and net balance sheet presentation methods are found in practice because differing facts and circumstances determine whether the unremitted fiduciary cash, the premiums receivable from the insureds, and the related premiums payable to the underwriters are assets and liabilities of the brokers and therefore includible on the brokers' balance sheets or whether such cash and receivables are assets of the underwriters since the brokers are merely acting in a fiduciary capacity. This divergence results primarily from the unclear nature of the implied or contractual legal relationships of the parties involved and the varying business practices followed by the brokers which determine the obligations created by those practices. Statement of Financial Accounting Concepts No. 6, "Elements of Financial Statements," sets forth the essential characteristics of a liability and includes a statement to the effect that "the existence of a legally enforceable claim is not a prerequisite for an obligation to qualify as a liability

if for other reasons the entity has the duty or responsibility to pay cash, ..." (see Concepts 6, paragraphs 35 and 36, including footnote 22). Consequently, even though some brokers' arrangements with underwriters related to premiums receivable from the insureds are not legally enforceable liabilities, their business practices indicate that the premiums payable to underwriters meet the definitional criteria for a liability and should be included in the brokers' balance sheets as liabilities. Similarly, fiduciary funds and premiums receivable, including future installment billings, for these brokers meet the definitional criteria for assets set forth in Concepts 6, paragraphs 25 and 26, and should be included in the brokers' balance sheets as their assets. Other brokers, based on their business practices, are acting only as fiduciaries, and, thus, the foregoing items should not be included in their balance sheets; under their business practices, the fiduciary funds, the premiums receivable from the insureds, and the related premiums payable to the underwriters do not meet the definitions of assets and liabilities in Concepts 6 and therefore are not included in the brokers' balance sheets. Accordingly, because the gross and net presentation methods are not alternatives for the same circumstances, each broker needs to evaluate its business practices, including formal and informal agreements with insurance carriers and clients, to determine if the gross or net presentation method is appropriate under the specific facts and circumstances. However, regardless of whether such items are or are not presented separately in the brokers' balance sheet (i.e., using either the gross or the net presentation method), the amounts of fiduciary funds, premiums due from clients, advances to underwriters and clients, and premiums payable to underwriters should be disclosed in the brokers' financial statements.

73. Investment income on fiduciary funds should be included in operating revenue and the amount should be disclosed in the brokers' financial statements.

WHOLESALE BROKERS

74. The revenue and expense recognition and the financial statement disclosure considerations relating to the operations of wholesale brokers, as briefly described in paragraph 7, are similar to those of retail brokers; accordingly, the conclusions in the paragraphs on retail brokers also apply to wholesale brokers.

REINSURANCE INTERMEDIARIES

General

75. Reinsurance is a transaction whereby one company, the assuming company, agrees for a consideration to indemnify another company, the ceding company, against all or part of the loss that the ceding company may sustain under a policy or policies it has issued. Reinsurance intermediaries facilitate the business of reinsurance by bringing together reinsurance sellers (assuming companies or reinsurers) and reinsurance purchasers (ceding companies or reinsureds). Reinsurance intermediaries generally represent the ceding companies and refer to such companies as clients. Reinsurance intermediaries usually design and negotiate the terms of reinsurance, place reinsurance, accumulate and report transactions, distribute premiums, and collect and settle claims between the two parties to the reinsurance agreement.

76. Reinsurance may be transacted under broad automatic contracts called treaties, which are usually renewed annually and which cover some portion of particular classes of business underwritten by the insurers. Treaties may either be pro rata or excess. In pro rata treaties, the assuming companies and the ceding companies share proportionally in the premiums and losses; in excess treaties, only the ceding companies' losses above a fixed negotiated point, known as the ceding company's retention, are reinsured and separate reinsurance premiums are charged for that portion of the overall risk. Reinsurance also may be transacted under facultative agreements, which cover specific individual risks and require the ceding companies and the assuming companies to negotiate and agree on terms and conditions of reinsuring each risk. In general, treaty reinsurance is a more significant part of reinsurance intermediaries' business than facultative reinsurance; however, some intermediaries deal only with facultative reinsurance.

Operations of Reinsurance Intermediaries

77. Although there are certain unique characteristics of reinsurance intermediaries' operations and functions, in general, some of their operations and functions are similar to those of typical retail brokers. Both reinsurance intermediaries and retail brokers operate in service industries and their operating revenues consist principally of the commissions, often referred to as brokerage, and fees that they receive for performing their services. Their costs are also related principally to the services that they perform. Such costs are primarily payroll and payroll-related costs, travel and entertainment, rent, data processing, and other selling and general administrative costs.

78. Assessing Needs. Similar to retail brokers, who often must assess the insurance needs of their clients and counsel with them to meet those needs, one of the main functions of reinsurance intermediaries is to identify and assess ceding insurance companies' reinsurance needs and to counsel and advise them to help them meet those needs. In summary, reinsurance intermediaries assist their ceding company clients to determine the clients' needs, to put the clients' risks before the assuming company's underwriters in as favorable a light as possible, to obtain the best terms for the clients when the reinsurance is placed, and to process claim settlements, collect amounts from assuming reinsurers, and pay the ceding insurance companies. To perform these duties, the reinsurance intermediaries must know the reinsurance market, be able to select the most suitable reinsurer for each risk, prepare and have executed by all parties the contract of reinsurance in its proper form, and provide help and guidance in the processing and handling of claims. Both retail brokers and reinsurance intermediaries normally perform those functions by visiting their clients to become familiar with their operations and insurance or reinsurance needs. Both draw on their experience and knowledge of the insurance or reinsurance industry to counsel their clients in fulfilling their insurance or reinsurance needs.

79. Marketing the Risk. Both retail brokers and reinsurance intermediaries normally represent their clients in finding and analyzing the kinds, terms, and quality of insurance or reinsurance available. Both retail brokers and reinsurance intermediaries are therefore interested in negotiating the best terms available on behalf of their clients while at the same time placing their clients' risks with financially sound and reputable underwriters acceptable to the clients. Sometimes, a retail broker may place a client's risks with several different underwriters. It is common for a reinsurance risk to be placed with a number of reinsurers and through corresponding brokers, and the reinsurance intermediary must deal with those various parties on behalf of the client. If the business cannot be fully placed, the terms of the coverage may be significantly revised after consultation with and the approval of the client to make it more acceptable in the reinsurance market. In some situations, a client's reinsurance needs may not be fully met until after the effective date of the primary coverage.

80. Both retail brokers and reinsurance intermediaries work on behalf of their clients, are compensated by the underwriters assuming the risk, and generally receive commissions based on percentages of the insurance or reinsurance premiums. Thus, the interests and method of compensation of retail brokers and reinsurance intermediaries are generally similar.

81. Transmitting Information and Money. Both retail brokers and reinsurance intermediaries usually are responsible for transmitting information and money between their clients and the insurance or reinsurance companies. Retail brokers normally are responsible for transmitting premium and loss information on behalf of their clients to underwriters. Also, it is customary for retail brokers to bill and collect the insurance premiums from their clients on behalf of the underwriters, and the brokers may collect loss proceeds on claims from the underwriters and transmit them to their clients.

82. Reinsurance intermediaries act as conduits between the ceding and assuming underwriting companies through which premiums are paid and losses are collected. Reinsurance intermediaries normally receive and

transmit all correspondence and accounting documents between the ceding underwriters and the assuming reinsurers or corresponding brokers. Premiums normally are paid to reinsurance intermediaries for transmittal to the assuming reinsurers, and the intermediaries present the ceding companies' proof of loss reports for claims to the assuming reinsurers and collect funds on the ceding companies' behalf, and, if needed, arrange for the establishment of and the drawing on letters of credit. If differences of opinion arise, the reinsurance intermediaries, like retail brokers, represent their clients in resolving the difference.

83. Drafting the Contract. One of the main functions of reinsurance intermediaries is to draft reinsurance agreements, which are binding contracts documenting the arrangements that have been negotiated between the ceding and assuming companies. Once drafted, the agreements normally are presented to the ceding companies for approval and signing and then to the assuming companies for their approval and signing. Although some reinsurance contract language is relatively standard, many reinsurance agreements involve matters that require extensive negotiation, and the reinsurance intermediaries normally represent the ceding companies in such negotiations. Because facultative reinsurance agreements involve unique risks, they may involve relatively greater efforts by the intermediaries in negotiating and drafting than do treaty reinsurance in comparison to the amounts of risks transferred. Because facultative reinsurance agreements involve specific risks, the brokers assist in the completion of certificates of reinsurance. The terms of the reinsurance agreements are usually reviewed by both the ceding and the assuming companies at least once a year, and the reinsurance intermediaries normally represent the ceding companies during the renewal negotiations in the same manner as in the original placements.

84. Retail brokers typically are not involved in drafting insurance policies on behalf of their clients. However, some retail brokers may have arrangements with insurance companies that permit them to exercise considerable latitude in the wording of insurance policies. Under

certain unusual arrangements, retail brokers may have as much latitude in drafting insurance policies on behalf of their clients as reinsurance intermediaries do in drafting reinsurance agreements.

Revenue and Expense Recognition

85. Servicing the Contracts. Reinsurance intermediaries, at their discretion, customarily service and report the run-off of claims and related reinsurance recoverable amounts associated with the agreements. Due to the long-tail nature of certain liability lines, reinsurance intermediaries may report claim activity to the assuming companies five to ten years after the treaties expire. Similarly, retail brokers may service and report their clients' claims covered by the insurance placed by the brokers. For many kinds of insurance normally handled by typical retail brokers, it is also common for such brokers to report claims activity to underwriters after the insurance policies expire. As with retail brokers, reinsurance intermediaries typically are not obligated, either by contract or by industry practice, to provide services subsequent to the placement of the reinsurance contracts. Reinsurance intermediaries provide, at their discretion, claims processing, and other services after placement of the coverage, typically to retain or increase business with the clients rather than to meet any obligation to service the reinsurance contracts. Accordingly, these subsequent servicing costs should be expensed as incurred as period costs. However, if the reinsurance intermediary specifically obligates itself by agreement with the client to provide services after placing the reinsurance contract, and the subsequent costs can be associated directly with the reinsurance contracts placed by the reinsurance intermediary, a portion of the intermediary's related revenue should be deferred (or costs should be accrued if such costs exceed deferrable revenue) and recognized as revenue as the services are performed.

86. Excess of Loss Reinsurance Contracts. Excess of loss reinsurance contracts generally are written for annual periods, with premiums typically paid on a quarterly or semi-annual basis. At the inception (effective date) of excess of loss reinsurance contracts, equal quarterly

or semiannual deposit premiums to be paid by the ceding company to the assuming companies are agreed-on based on information available to estimate the premiums that will be written or earned under the contracts. These deposit premiums may represent minimum or guaranteed amounts that guarantee a minimum commission to the reinsurance intermediary. Premium adjustments often are determined and billed after the last quarter to arrive at the ultimate total premium, and it is also common practice for such deposit premiums to be adjusted before the last quarter or in the subsequent period.

87. Because the estimated deposit premiums, in the aggregate, generally do not exceed the ultimate premiums to be earned, reinsurance intermediaries should recognize revenue from commissions, brokerage, and fees in lieu of commissions from excess of loss reinsurance contracts as each deposit premium becomes billable. Because the deposit premiums are estimated, the business written during the contract period determines the final premium due. When this information is known, the cedants are billed for the differences between the deposit premium and the ultimate premium. Revenue related to these premium adjustments should be recognized by the reinsurance intermediaries when billed. In circumstances where there is a minimum guaranteed commission, the minimum commission should be recognized by the reinsurance intermediary at the inception of the contract since the revenue recognition method should not be tied to the cash flow effects of the intermediary's billing arrangements with its cedents and markets.

88. <u>Pro Rata Reinsurance Contracts</u>. Pro rata reinsurance contracts usually provide for continuing coverage and, as such, usually have no expiration date, but continue until the business runs off, that is, until the covered claims are settled and paid or the contracts are canceled. At the inception (effective date) of pro rata reinsurance contracts, there generally is insufficient information to reasonably estimate the amount of premiums that will be written or earned under the contract. Consequently, reinsurance intermediaries do not recognize commission revenues at the beginning of the contract, but rather as the ceding companies report information on premiums written and pay their reinsurance premiums. Premiums written are the amount of the premiums

billed or collected on the underlying insurance policies; premiums earned are the pro rata portion of the premiums written applicable to the expired period of the policies. The ceding companies generally report the premiums written and the reported or incurred claims to the intermediaries on a periodic basis, and the intermediaries, in turn, report this information to the assuming companies. There generally is a lag between the end of a reporting period and the date on which a ceding company submits reports to the assuming companies.

89. Pro rata reinsurance contracts usually provide for settlements between the ceding company and the assuming company on a net basis, i.e., the ceding company deducts reimbursements due from the assuming company from premiums due to the assuming company. However, the intermediaries' commissions are based on the gross premium amounts, not the net cash settlement amounts.

90. For pro rata reinsurance, the reinsurance premiums are not predetermined. Therefore, based on ceded premiums included in the periodic statements that are received from the ceding companies, reinsurance intermediaries should recognize revenue from commissions, brokerage, and fees in lieu of commissions from pro rata reinsurance contracts on the date that the premiums are billable to the assuming companies.

91. Foreign Reinsurance. Another aspect of reinsurance intermediaries' operations that differs from those of typical retail brokers is the relatively large volume of reinsurance involving foreign insurance organizations for which pertinent and desirable financial data may not be readily available. As a consequence, the reinsurance intermediaries may undertake to review and evaluate the financial responsibility and stability of such foreign entities on behalf of the ceding companies; the reinsurance intermediaries may provide this service to their clients because the intermediaries can accumulate such financial information periodically and make it available to all of their clients. The ceding companies, not the intermediaries, decide which assuming companies are to be used. Also, a reinsurance arrangement between a U.S. entity and a number of foreign entities often involves more than one intermediary and generally implies an increased time lag for the U.S. entity to receive

information on the results of the reinsurance contract, and the detail and the classification of the information provided can vary significantly. As a result, adequate information to make accounting estimates for foreign reinsurance assumed often is not available on a timely basis; for similar reasons, financial data needed to evaluate the financial condition of foreign insurance companies is frequently not available on a timely basis.

92. Retrospective Commission Adjustments. The premiums on some reinsurance arrangements are retrospectively rated. The amounts of the claims determine the amounts of the reinsurance premiums, which, in turn, determine the amounts of the reinsurance intermediaries' commissions. As with retail brokers, the retrospective adjustments, which could result in additional commissions or return commissions, should be recognized when such amounts become known to the reinsurance intermediaries.

93. Expense Recognition. Reinsurance intermediaries' costs are similar to those of retail brokers; accordingly, the conclusions described in paragraphs 66 and 67 for retail brokers also apply to reinsurance intermediaries and brokers.

Financial Statement Presentation

94. The conclusions on financial statement presentation for retail brokers, as described in paragraphs 72 and 73, also apply to reinsurance intermediaries and brokers.

MANAGING GENERAL AGENTS

General

95. Managing general agents ("MGAs") are persons or organizations that have authority to underwrite and bind risks on behalf of their client underwriters. The function of MGAs in the underwriting of risks generally requires the experience and ability to evaluate the acceptability of risks and to determine the appropriate premiums. As such, MGAs typically are more directly concerned with and have greater knowledge of the underwriting results of the business written than do retail brokers. Also, MGAs typically have relatively larger back office functions to process and administer the business written than do retail brokers, whose efforts are directed more toward prospecting and marketing. Although MGAs operate in many respects as underwriters, the client underwriters, and not the MGAs, bear the primary insurance risk. However, some entities referred to as MGAs retain all or portions of the insurance risks described in FASB Statement No. 60, "Accounting and Reporting by Insurance Enterprises."

96. The structures and organizations of MGAs vary considerably. An MGA may be an autonomous organization or may be part of the operations of an insurance broker. MGAs may operate on behalf of one or more underwriters, in particular geographical areas, or for given blocks of business, including life insurance. MGAs may manage captive insurance companies, insurance pools, or syndicates for groups of underwriters or investors.

97. The services and obligations of MGAs vary depending on the terms of the agreements with the client underwriters. For example, MGAs may be responsible for or guarantee the earned premiums due the underwriter and could be required to service the run-off of business on canceled managing general agent agreements. In addition to underwriting and binding risks

on behalf of the client underwriters, MGAs may also provide a broad range of services to the client underwriters, including:

- Administration of the affairs of the underwriters, including the reinsurance program of the underwriters.

- Investment of premium funds.

- Adjusting and settling of claims.

- Maintaining the books and records of the underwriting companies, syndicates, or pools.

- Preparation of reports and financial statements to be filed with insurance regulatory authorities, including assistance with rate filings.

- Assistance with or preparation of reports for filing with statistical agencies.

Comparison of MGAs and Brokers

98. Both MGAs and brokers operate in service industries, receive commissions and fees for their services, and incur similar operating costs. In many respects, MGAs and brokers perform similar services, with some notable exceptions.

99. Generally, both MGAs and brokers provide underwriting and claims expertise and services and act as conduits to the insurance market for their clients. MGAs, however, represent the underwriters, while brokers represent the insureds. MGAs, acting on behalf and within the authority or guidelines established by the underwriters, bind and accept or reject insurance risks on behalf of the underwriter and may perform significant additional functions concerning the business written; in contrast, brokers generally do not have such authority and do not provide such extensive services after placement of coverage with the underwriters.

100. MGAs and brokers both operate in a fiduciary capacity by processing cash receipts and disbursements related to premiums and claims. However, MGAs sometimes process and control all the funds on behalf of the underwriters they represent, while brokers usually are required only to collect, hold, and account for the client or underwriter funds.

101. MGAs, unlike brokers, are usually responsible for the future servicing of claims, depending on the agreements between the parties. Therefore, the functions and responsibilities of MGAs are significantly greater than those of brokers, because MGAs are usually contractually obligated, or may specifically agree with the underwriters, to continue to settle and adjust claims even after the managing general agents' agreements have terminated.

Revenue and Expense Recognition

102. Commissions and Fees. MGAs may receive compensation for services in one or more of the following forms:

- Commissions (or overrides) as a percentage of premiums written, earned, or collected, which may also include a minimum fixed fee amount and/or a sliding commission scale based on premium volume produced.

- Fees for services performed or cost-plus arrangements.

- Fixed fees for a specified period or for specified services, that is, an unbundled approach.

- Reimbursement of certain expenses incurred, such as for data processing services.

- Profit participation in the underwriting results or in the net income of the operation.

103. Commissions and fees may be charged together or separately for certain kinds of services, such as underwriting, administration, and claims adjusting. MGAs may operate on behalf of several separate underwriters and could be reimbursed for certain direct and indirect costs associated with servicing each underwriter. MGAs may also act as brokers or agents and obtain business for the underwriter or for the entities that they manage, for which the MGAs would receive separate commissions.

104. MGAs have adopted diverse revenue recognition practice as follows:

- As the commissions are billed to the underwriters, based on the premiums billed or collected on behalf of the underwriters, which may include installment and deposit premiums.

- As the premiums are billed on behalf of the underwriters.

- As of the effective dates of the underlying policies.

- On a pro rata basis over the policy period.

105. Historically, MGAs have recorded commission adjustments for subsequent policy cancellations, audit adjustments, or premium volumes when they occurred. Fixed fees generally have been recognized as earned over the contract period.

106. Although brokers may perform other services before (marketing) and after (subsequent servicing) placement of insurance coverage with underwriters, the placement of insurance coverage is the predominant function for which brokers receive commissions. The predominant function of an MGA is the performance of a broad range of services relating to underwriting and managing the business on behalf of the client underwriters, not the placement of insurance coverage. Though an MGA's compensation may be in the form of commissions, the nature of the compensation is a fee for all services to be performed. Therefore, commissions and fees of MGAs should be recognized in relation to the

services performed but not before those revenues are realized or realizable, which is ordinarily the effective date of the contracts. If the services are performed relatively evenly over the terms of the contract period, commissions and fee revenue should be recognized pro rata over the contract period. However, commission adjustments should be recorded as they occur or become known to the MGAs.

107. Contingent Profit Commissions. MGAs' profit participation (the contingent profit commissions) in the underwriting results or net income of the businesses managed by the MGAs may be structured by agreement in various ways. The contingent profit commissions generally are specified percentages of the profits as defined in the agreements for a given year or group of years, such as fiscal, calendar, syndicate, or pool years. The defined profits may be based on results determined in accordance with generally accepted accounting principles or in accordance with accounting practices prescribed or permitted by insurance regulatory authorities. The defined profits may contain arbitrary percentages or amounts for unearned premiums, loss reserves, or specified expenses on each calculation date. The contingent profit commission payments to the MGAs may be payable within a short time after a particular year or may begin only after a number of years have passed after the issurance was written. In either case, the commission calculations may be subsequently adjusted as actual loss experience develops. The experience of a particular year may be carried back or forward for a number of years and, accordingly, could potentially increase, reduce, or eliminate the contingent profit commissions previously received or to be received.

108. Contingent profit commissions are based on the results of business underwritten by the MGA and generally are not determined and paid until after the end of specified periods. Some contingent profit commissions are based on only the results of the current underwriting year; however, such contingent profit commissions generally are based on the results of a number of years. Under some arrangements, adverse loss experience in future years may require the MGA to pay back contingent profit commissions already received.

109. Unlike a typical retail broker, an MGA often administers the underwriting and the claims functions of the business it writes. An MGA may therefore have the information on profit experience of the subject business needed to estimate its contingent profit commissions. Historically, the recognition practices for contingent profit commissions varied among MGAs and included the following practices:

- Some MGAs recognized contingent profit commissions when received regardless of whether the commissions may be contingently returnable to the underwriter, based either on business already written or for business yet to be written. These MGAs have recognized adjustments to contingent profit commissions already received when such adjustments occurred.

- Some MGAs have recognized contingent profit commissions when they were received but only if they were not returnable to the underwriters should adverse loss experience develop for business already written or for business yet to be written.

- Some MGAs have recognized contingent profit commissions using accruals based on estimates of underwriting experience on the business that had been written. The accruals have been adjusted as actual experience became known. If MGAs have not had sufficient information to reasonably estimate contingent profit commissions, the MGAs have recognized such commissions when they received them or when they have been notified by the underwriters as to the amount of such commissions.

- Some MGAs have recognized contingent profit commissions using accruals as described in the preceding description, but only to the extent that the commissions would not be reduced or eliminated by any carryback of adverse loss experience for business yet to be written.

110. Contingent profit commissions should be accrued and recognized as revenue when such commissions are determined on the basis of the underwriting results of current or past periods and if the MGAs can reasonably estimate the amount of such commissions based on information or experience with the business written. The timing of the payments of such contingent profit commissions is a matter of negotiation between the underwriters and the MGAs and should not necessarily determine the timing of revenue recognition for the MGAs. The revenue should be recognized as the services are performed that result in the commissions. Any future paybacks of commissions caused by adverse experience of future periods should be recognized as losses in those periods, and any subsequent modifications or adjustments to prior contingent profit commission revenue represent changes in estimates that should be accounted for in those future periods.

111. The ability to reasonably estimate contingent profit commissions varies depending on the stability of the business written and the information available to the MGAs. If these commissions cannot be reasonably estimated, the MGAs should recognize only that portion of the provisional profit commissions that represents the guaranteed minimum commission element. This practice is similar to the accounting by underwriters for some of their premium revenues. Many underwriters recognize premium adjustments using estimates of loss experience that has occurred, and the kind of information on which those estimates are made is generally available to the MGAs. The accounting by underwriters for premium adjustments is described in FASB 60, paragraph 14, as follows:

> If premiums are subject to adjustment (for example, retrospectively rated or other experience-related insurance contracts for which the premium is determined after the period of the contract based on claim experience or reporting-form contracts for which the premium is adjusted after the period of the contract based on the value of insured property), premium revenue shall be recognized as follows:
>
> - If, as is usually the case, the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. The estimated ultimate premium shall be revised to reflect current experience.

- If the ultimate premium cannot be reasonably estimated, the cost recovery method or the deposit method may be used until the ultimate premium becomes reasonably estimable.

112. Contingent profit commissions subject to future performance or underwriting results of future periods should not be recognized as income until the future performance requirements have been met or until future underwriting periods have ended and the related profitability levels can be reasonably estimated. Adjustments to reported contingent profit commission revenues should be recognized as information on actual experience becomes available.

113. Expense Recognition. An MGA's costs, like those of a retail broker, are primarily payroll and payroll-related costs, travel and entertainment, rent, and other general and administrative costs. A portion of the costs are incurred early, in prospecting and underwriting new or renewal business before the policy effective dates. MGAs also incur costs after the policies are issued for administrative, accounting, and claims settlement services. Under the typical MGA agreement, the MGA usually is obligated to continue to service run-off business, for example, servicing claims after the managing general agent's agreement with the underwriter has been terminated. MGAs could also incur losses for uncollected premiums to the extent of any guarantee of premium collections in such MGA agreements.

114. Historically, MGAs have expensed all of their costs when incurred. MGAs have not deferred direct costs incurred to generate revenues in future periods. Also, MGA's generally have not given current recognition to future servicing costs, such as for the run-off of claims for which the MGAs are responsible according to the management agreements, and they have not separately identified fees for such services.

115. MGAs should continue to expense all of their costs as incurred. However, a loss should be recognized currently if it is probable that future expenses related to contracts in effect at the balance sheet date will exceed any future revenues on those contracts that relate to periods prior to the balance sheet date.

116. Reimbursements to the MGAs for expenses, including those incurred in connection with cost-plus arrangements, should be recognized as the applicable costs are incurred.

117. When premiums due the underwriter that are guaranteed by an MGA are deemed to be uncollectible, a loss should be recognized in the amount of the earned portion of the premium and all related commissions.

Financial Statement Presentation

118. The conclusions on financial statement presentation for retail brokers, as described in paragraphs 72 and 73, also apply to managing general agents.

General

119. This section describes some unique considerations that relate to the operations and accounting of life insurance agents and brokers (referred to herein as brokers). In addition to dealing in life insurance, life insurance brokers often deal in accident and health insurance, employee benefit services, and related services. The discussion in the preceding sections of this guide that focuses on retail property and casualty insurance also applies to accident and health insurance, group insurance plans, employee benefit services, and short-duration term life insurance, because certain aspects of those policies and the related broker services and commission arrangements are similar to those of retail property and property insurance. However, because of their long duration, other kinds of life insurance may present certain unique issues.

120. Substantial amounts of life insurance are sold by brokers who act as independent agents. Independent agencies often are organized as proprietorships or closely-held corporations. As such, they often do not prepare general-purpose financial statements, and many of their reporting practices are influenced by income tax considerations.

121. Life insurance is also sold by the direct sales forces of life insurance underwriters. Because few direct sales forces are separate entities, the discussions in this guide do not apply to direct sales forces. Commissions paid to such forces and certain other costs are capitalized by the underwriters as policy acquisition costs and are amortized to match the recognition of premium revenues. Those costs should be considered within the broader framework of accounting practices of insurance enterprises, which are specified in FASB 60 and further discussed in the AICPA Audit Guide, "Audits of Stock Life Insurance Companies."

122. Some stockbrokers have operated as independent insurance agents and have marketed substantial amounts of certain kinds of life and annuity products, particularly those that are believed to have inherent policyholder tax savings, tax deferral, or investment features.

123. Life insurance may also be one of the personal lines of business of brokers who also service the property and casualty insurance needs of their commercial clients. For larger brokers, life insurance has been less significant than their property and casualty business. Brokers may also provide life insurance through group merchandising programs to professional or trade associations or other large groups, using techniques such as direct mailings and payroll deduction plans.

Services Provided by Life Insurance Brokers

124. One major difference between life insurance and property and casualty insurance is that there can be only one claim under a life policy but there can be more than one claim under a property and casualty policy. Thus, a relatively smaller portion of a life insurance broker's effort is devoted to providing services after the effective date of life policies. The subsequent services may consist of maintaining contact with the policyholders, billing and collecting premiums (although this may be done directly by the underwriters), advising the policyholders on benefit options, and so forth. Because a relatively smaller portion of a life insurance broker's effort is expended after the effective date, a relatively larger portion can be devoted to looking for new business and designing and negotiating life insurance programs.

Revenue and Expense Recognition

125. Commissions. Most life insurance brokers are compensated by commissions, which are either withheld by the brokers, who then remit the net premium amounts to the underwriters, or which are transmitted to the brokers by the underwriters if the premiums are billed directly by the underwriters.

126. Unlike most property and casualty insurance, which is usually written under annual policies, a substantial portion of life insurance is written under long-duration policies that provide for the payment of periodic premiums over a period of several years. Brokers usually receive relatively high commissions when the life policies are sold and lower renewal commissions in later years as subsequent premiums are collected. The terms of the commission arrangements between the broker and the underwriter are individually negotiated and vary significantly. A fairly typical arrangement for an ordinary life insurance policy is a first-year commission equal to one year's premium, with renewal commissions for the next nine years at five percent of the annual premiums paid and a servicing commission for subsequent years at two percent of the annual premiums. Another broker, however, might receive commissions under a similar policy equal to forty percent of the annual premium for the first three years with no subsequent renewal commissions. Commission arrangements also vary with the kinds of policies. For example, first-year commission rates under ordinary life insurance policies with fixed premiums and benefits are ordinarily higher than those for universal life insurance policies with variable premium and benefit features. Under some arrangements, brokers' renewal commissions may become vested, that is, the brokers maintain the right to receive renewal commissions even if the brokers terminate their relationships with the underwriters.

127. Historically, brokers have recognized commissions on life insurance when the related premiums were collected by the broker or billed by the underwriter.

128. First-Year Commissions. The annual premiums on long-duration life insurance are not the same as installment billings for property and casualty insurance, which cover only short durations. Therefore, first-year commissions on long-duration life insurance policies should be recognized as income when the first premium is paid by the insured and accepted by the underwriter, regardless of whether the first-year premium is paid as a single premium or as a series of monthly, quarterly, or semi-annual premiums.

129. Renewal Commissions. Though life insurance brokers may not be obligated to provide significant future services to receive renewal commissions, such renewal commissions are subject to the uncertainty that the policyholders will terminate or not renew the policies. Thus, recognizing renewal commissions when the policies are issued could result in recognizing income that may never be realized. Therefore, renewal and servicing commissions should be recognized by life insurance brokers as revenue when renewal premiums are paid by the insureds or when premiums are paid under an automatic premium loan option.

130. Persistency Bonus Commissions. In addition to regular commissions, persistency bonus commissions may also be paid to life insurance brokers. Such commissions typically are based on the amount of premiums remaining in force for three or more years. For example, for a given broker, a five percent persistency bonus would be paid if at least seventy percent of the business written in a given year was still in force after three years. Therefore, persistency bonus commissions should be recognized by life insurance brokers in the same manner as contingent profit commissions of MGAs are recognized, as described in paragraphs 110 through 112.

131. Commission Adjustments. The only commission adjustments generally occurring after the effective date of life insurance policies are caused by policy cancellations. Cancellations of policies sometimes require brokers to return previously received commissions. This situation is typical, for example, for policies in which the premiums are billed monthly but the full first-year commission is paid to the broker when the first monthly premium is paid by the policyholder. Therefore, adjustments to commissions due to cancellations of policies should be recognized when the broker is notified by the underwriter of such cancellation. If annual commissions are paid to brokers in advance of the collection of monthly or other installments of annual premiums, a provision should be made for estimated adjustments due to cancellations, if such a provision can be reasonably estimated.

132. Expense Recognition. The costs of life insurance brokers are similar to those of retail brokers. The relative proportions that may be classified as initial direct, subsequent servicing, and indirect costs may differ but the conclusions for retail brokers, as described in paragraphs 66 and 67, nevertheless also apply to life insurance agents and brokers.

Financial Statement Presentation

133. The conclusions on financial statement presentation for retail brokers, as described in paragraphs 72 and 73, also apply to life insurance agents and brokers.

EXPENSE RECOGNITION BY BROKERS AFFILIATED WITH INSURANCE UNDERWRITERS

134. Historically, various expense recognition methods have been used by brokers who were directly or indirectly affiliated with insurance underwriters, either as subsidiaries, parent companies, or brother-sister corporations, collectively referred to herein as affiliated brokers.

135. Some affiliated brokers have expensed all the costs related to their services as incurred. Other affiliated brokers have deferred only the direct costs that were related to the acquisition of the insurance business that was placed with their affiliated insurance underwriters. Still other affiliated brokers have deferred the direct costs related to the acquisition of all the insurance business that they produced, regardless of whether that business was placed with their affiliated insurance underwriters or with nonaffiliated insurance underwriters.

136. Affiliated brokers should follow the general authoritative guidance on consolidated financial statements in Accounting Research Bulletin No. 51, "Consolidated Financial Statements," and on related party transaction disclosures in FASB Statement No. 57, "Related Party Disclosures."

137. In separate financial statements, affiliated brokers should charge their costs to expense, as described in paragraphs 64 and 65, regardless of their relationships with insurance underwriters, because their operations typically are similar to those of other brokers not directly affiliated with insurance underwriters. Charging costs to expense as described in these paragraphs will enable comparability of financial statements among brokers.

138. Consolidated reporting entities comprised of affiliated brokers and insurance underwriters should account for acquisition costs related to the acquisition of insurance policies underwritten by the entities in accordance with FASB 60, paragraphs 28 to 31, after elimination of intercompany commissions paid by the insurance underwriters to the affiliated brokers.

139. Because their operations are similar to direct sales forces of insurance underwriters, affiliated brokers should defer costs related to the acquisition of the insurance business that is placed with their affiliated insurance underwriters for purposes of consolidated financial statements. The affiliated brokers should capitalize any unreimbursed costs as a form of deferred policy acquisition costs and should amortize those costs against either their related revenue or that of their affiliated insurance underwriters.

140. An accounting policy of deferring acquisition costs of affiliated brokers in consolidated financial statements is similar to many other forms of purchase accounting in which subsidiaries adopt the parent companies' accounting policies for the same or similar portions of their operations.

Separately Identifiable Intangibles Other Than Goodwill

141. Historically, the kinds of separately identified intangibles and the amounts assigned to them in accounting for the acquisition of brokers accounted for by the purchase method have varied with the circumstances of each such transaction. To some extent, specific identification and valuation of separate intangible assets appears to have been a function of the relative size of the transaction and the relationship of the total consideration paid by the buyer to the net tangible assets of the acquired entity.

142. Some acquirers, particularly in larger transactions or those in which the purchase price significantly exceeded the net tangible assets acquired, have tried to separately value specifically identifiable intangible assets other than goodwill, such as the intangible assets discussed herein, based on comprehensive studies. Others have concluded that it is impractical to analyze any excess purchase price over net tangible assets acquired beyond identifying that amount as goodwill.

143. Acquirers should separately identify and value the intangible assets acquired to conform with the requirements of APB Opinion No. 17, "Intangible Assets," paragraph 26. The separately identifiable intangible assets should be amortized over their estimated useful lives; however, the amortization period should not exceed forty years.

Intangibles--General

144. The principal intangibles of brokerage operations to which values might be assigned could include the following:

- Renewal rights.

- Employment and management contracts and noncompete agreements.

- Equity valuation of affiliates, foreign subsidiaries, and other investments.

- Operational systems, for example, coded software and written operational procedures and materials.

- Leasehold interests.

- Licenses.

- Goodwill.

Renewal Rights

145. A major portion of the cost paid to acquire an insurance broker is incurred for the prospect of future renewal commission income from the established customer base (known as policy expirations, books of business, or renewal rights).

146. Renewal rights normally are evidenced by signed broker of record letters, which authorize the brokers to negotiate directly with underwriters to place insurance on behalf of the clients. Therefore, even though insurance policies in force may expire, the brokers continue to have the renewal rights to current policies until the clients rescind the broker of record authorizations.

147. Appraisers generally value renewal rights at the present value (i.e., the discounted amount) of the projected future earnings attributable to such rights, as follows:

- Anticipated gross renewal commission income on an account-by-account basis, assuming expected attrition rates based, for example, on each account, broker, and industry historical experience, the current economic and business environment, the kinds of coverage, and the size and location of the clients.

- Ongoing administrative and servicing costs, including income taxes, for each account based on assumed inflation rates. Costs of new account prospecting and development are not allocated to each account.

- Appropriate interest rates are to be used in the discounting process.

148. Amortization of Renewal Rights. An analysis of the anticipated continuation of renewals related to particular customer bases or book of business (lifing analysis) used should be consistent with the assumptions used in determining the values assigned to renewal rights. APB 17 supports the straight-line method of amortization, unless another systematic and rational method can be shown to be better in the circumstances. Because renewal rights represent the value of future renewal commission income, the assigned value generally should be amortized in proportion to the ratio of annual renewal commission income to the present value of the total commission income anticipated from the purchased policy expirations. This approach should take into consideration the declining cash flows and the time value of money.

149. Subsequent reviews of amortization, as required by APB 17, paragraph 31, may cause adjustments to the amortization if subsequent experience differs significantly from the underlying assumptions used to initially record the assets or to determine their amortization.

Employment and Management Contracts and Noncompete Agreements

150. Employment and management contracts and noncompete agreements, though not unique to insurance brokers, may represent relatively important assets obtained and obligations assumed under acquisition agreements, because employee costs are typically the largest costs of brokers. Noncompete agreements restrict former owners, employees, or agents from competing against the acquiring company, in an attempt to preserve the business environment it acquired and to alleviate the potential for loss of future earnings.

151. Assignments of values should reflect employment contract and noncompete provisions. Obligations under noncancellable contracts should be estimated and discounted in accordance with APB Opinion No. 16, "Business Combinations," paragraph 88. The related assets should be amortized in proportion to the benefits to be received under the contracts. The amortization periods should be the periods over which services are to be rendered to the broker under the contracts. The amortization methods should reflect the ratios of periodic services provided to the total services to be provided over the contract periods.

152. Cancellable contracts typically do not have unconditional obligations that would establish the assignment of value. Consideration should be given to management's intentions and its past record regarding renewals of these otherwise short-term contracts.

153. Because noncompete agreements have no liquidation value and cannot be sold, the value assigned to them could only be the cost to the acquiring company, which amount should equal the obligations under the noncompete agreements. Also, the value assigned should reflect the difficulty of legally enforcing such agreements.

Affiliates and Other Investments

154. Foreign and partially owned affiliates and investments generally are valued using the discounted cash flow of net asset value approach. Such values generally are not amortized or are amortized over forty years or shorter periods, if warranted, e.g., in a joint venture agreement.

Operational Systems

155. Operational systems are intangible assets that provide the acquired brokers with procedures for operating the business. Computer software makes up a large part of these intangibles. Internally developed software generally has been recorded at current cost, by determining the person-days devoted to designing, coding, documenting, testing, and debugging each software system.

Economic obsolescence should be considered in the determination of the estimated remaining lives of the software systems. Externally developed software should be recorded at an appropriate value at the date of the business combination.

156. Internally generated and prepared materials include, for example, manuals, handbooks, video tapes, and sales kits, which are produced for and by the brokers and which will continue to be used by the company for several years before they are replaced. These items should be recorded at an appropriate value at the date of the business combination.

Leasehold Interests

157. Leasehold intangible assets or liabilities are caused by the brokers' lease rents being favorable or unfavorable compared to current market rents. Leasehold interests should be recorded by computing the present value, after tax, of the economic advantage or disadvantage and should be amortized over the life of the lease.

Licenses

158. The acquired broker, particularly if it has insurance underwriting subsidiaries, may have various licenses or "approvals" to operate in certain states. Since an underwriter cannot write business without these licenses or approvals, these operating rights have inherent value. Such licenses should be recorded at an appropriate value at the date of the business combination.

Goodwill

159. Goodwill encompasses all other unidentified assets (i.e., the residual method) and includes the "going-concern" value.

Abstract - A form prepared containing basic data shown on a policy.

Account Current or Agent's Account - A statement usually prepared by the agent for his or her month's business, showing for each premium transaction the balance due either to the underwriter or to the agent.

Account Executive - The person who takes the overall responsibility for management of all aspects of an insured's account.

Accounts Receivable - The amounts due the broker from clients for insurance premiums or services charged on a fee basis.

Additional Premium - The premium due from the insured for an endorsement.

Advance Billing - A billing rendered to a client before the effective date of the policy.

Advance of Premium to Underwriter on Behalf of Client - A payment by the broker to the underwriter of the client's premium before the client pays the premium to the broker.

Affiliated Broker - A broker directly or indirectly affiliated with an underwriter either as a subsidiary, a parent, or a brother-sister corporation.

Aged Accounts Receivable Trial Balance - A report indicating amounts overdue over ninety days, sixty to ninety days, and thirty to sixty days and indicating current items and the total account balance.

Agency Company - An insurance company (underwriter) whose business is produced through a network of agents, in contrast to a direct writing company, whose business is produced by company employees.

Agency System - The system of producing business through a network of agents. Such agents have contracts to represent the company and are of three classes, i.e., local, regional, and general. These agents are compensated at differing rates of commission, and general agents have much greater responsibilities and duties than local and regional agents.

Agent - A licensed representative of an insurance company in negotiating, servicing, or effecting insurance contracts. An agent may, in fact, represent several insurance companies. For purposes of this guide, all references to agents are identical to brokers unless otherwise noted.

Advance of Claim Settlement/Premium Refund - The payment by a broker to an insured on behalf of the underwriter for settlement of a claim or refund of premium before the broker receives the settlement or refund payment from the underwriter.

Agent, General - An independent person or organization that operates the way a branch office of an insurance company operates. The person or organization usually performs the function of an insurance company in selecting, writing, and servicing business for the insurance companies represented. A general agent may use sub-agents and brokers to market the products of the companies represented.

Anniversary Date - The date on which the next annual premium is due for policies written for more than one year with premiums payable annually.

Assuming Company - An insurance underwriter that accepts all or part of an insurance risk from another underwriter through reinsurance.

Assured or Insured - The person or entity in whose name the insurance policy is issued and whose life, property, or liability exposure is insured.

Audit - In certain kinds of insurance, a survey of the insured's records during or at the end of the policy period to determine the earned premium for the period that coverage was in force. An audit may also be defined as a review of the client's insurance program to determine the adequacy of its coverage or rates.

Audit Premiums - Earned premiums determined from data developed by periodic audits of insureds' records or from periodic reports submitted by insureds. Such audits are made and such reports are submitted either monthly, quarterly, semiannually, or annually.

Billing Date - The date a billing is prepared. It does not necessarily coincide with the effective, expiration, or term dates of the policy.

Binder - A temporary insurance contract created to confirm to the client that coverage is in force pending creation of a formal policy contract. In some instances, the broker may invoice the anticipated premium along with the binder to expedite eventual collection of premiums. In these situations, a "premium-bearing binder" is issued.

Bordereau - A detailed list of premiums and/or claim transactions, usually prepared monthly, and rendered to interested parties. Such lists are also frequently rendered by ceding companies to reinsurers and by large general agents to underwriters.

Broad Form Cargo Policy - Insurance covering the value of cargo during a specific voyage, commonly written on a reporting-form basis.

Broker - A representative of the client who places the client's insurance with an underwriter. The compensation for his services generally consists of a commission paid to the broker by the underwriter. The broker is not an agent of the underwriter and the commission that the broker receives is usually lower than that of an agent who represents the underwriter. Brokers also may provide services other than the placement of insurance.

Broker of Record - The broker who placed the current coverage and thus is entitled to receive commissions related to the placement of that coverage and has undertaken to service the coverage for the client.

Builders' Risk Policy - Insurance covering the increasing values of property at various stages of construction, commonly written on a reporting-form basis.

Bundled Transaction - A transaction in which the broker receives a single fee for placing insurance coverage and for providing services that do not relate to obtaining insurance coverage.

Cancellation - Termination of an insurance contract by the insured, the insurer, or the broker before it expires.

Cancellation, Flat - Cancellation of an insurance contract with a full return of the premium by the insurer.

Cancellation, Pro Rata - Cancellation of an insurance contract with a refund of the portion of the premium that the remainder of the policy period bears to the total policy period.

Cancellation, Short Rate - Cancellation of an insurance contract with a return of premium of less than the amount of premium refundable on pro rata cancellation.

Carrier - The bearer of the risk related to an insurance policy.

Casualty - A class of insurance that generally includes legal liability, workers' compensation, automobile, and aviation insurance.

Ceding Company - An insurance underwriter that transfers all or part of an insurance risk to another underwriter through reinsurance.

Claim (Loss) - A demand by the insured for payment by the underwriter of a policy benefit because of the occurrence of an insured event such as death, injury, destruction, or damage.

Claim Settlement - The amount paid by an insurer to or on behalf of an insured to discharge the insurer's obligation under the terms of the policy.

Claims Incurred But Not Reported ("IBNR") - Claims relating to insured events that have occurred but have not yet been reported to the underwriter as of the reporting date of the financial statements.

Client - A person or organization, such as the policyholder or insured, for whom insurance is placed or other services are performed by the broker or reinsurance intermediary.

Client Advance - A payment by the broker to the client of claim settlement or return premium amounts before payment of those amounts to the broker by the underwriter.

Commercial Lines - Coverage for business enterprises, rather than for persons. Commercial lines include, for example, insurance for damage to property, liability indemnity insurance, workers' compensation insurance, and group life and health insurance.

Commission - A portion of the premium paid to a broker or handled by a reinsurance intermediary. Generally, the broker or the reinsurance intermediary collects the total premium from the client, retains his commission, and remits the net premium amount to the insurer or reinsurer.

Commission Adjustment - Changes in the amount of commissions on discovery of errors made in calculating commissions or premiums or on audit of retrospective basis coverage.

Commission, Contingent - A profit-sharing commission the amount of which depends on the profitability of the business written by a broker with a particular underwriter. Contingent commissions are subject to the provisions in agreements that the broker has with its underwriters.

Commission, Contingent Profit - A commission paid to a managing general agent based on the profits, as defined in the MGA's agreement, of the business managed by the MGA.

Commission, Negotiated - A commission determined by agreement between the broker and the client at a rate different from that for regular commissions.

Commission, Provisional - A commission paid to a broker that may be subject to subsequent adjustment, such as under a contingent profit commission arrangement.

Commission, Regular - A commission at a rate specified by the underwriter or determined by agreement between the broker and the underwriter.

Credit Risk - The risk relating to the ability to collect money that will come due.

Customer Refund - A return of all or part of a premium paid by a client, usually as a result of a cancellation or overpayment.

Daily Report ("Daily") - A copy of the parts of an insurance contract that apply to a particular risk kept by the broker's office as its record of a policy in force for a client. The daily contains all the necessary premium billing information to create an invoice for the client. It is retained in the client's file indicating in-force coverage.

Deposit Premium - The initial premium payment under an insurance contract where the total premium is yet to be determined by audit.

Differences - A term applied to the differences developed as a result of comparisons made of accounts current rendered by an agent with transactions shown on the underwriter's records. Such differences are common because the agent and the underwriter each use different cutoff dates and because of errors and omissions by either the underwriter or the agent.

Direct Bill - Policies billed directly to the insured by the underwriter, with the broker assuming no responsibility for premium collection.

Direct Commissions - Commissions received directly from the underwriter on coverages for which the client has paid the premium directly to the underwriter. Direct commissions are most common with personal lines coverages, employee benefits coverages, and life insurance.

Dividend - A payment by an underwriter to a policyholder based on surplus or earnings on a participating policy.

Earned Premium - The portion of a premium applicable to the expired period of a policy, usually determined on a pro rata basis.

Effective Date - The date from which protection is afforded under an insurance policy. Also, the date from which an endorsement to a policy amends the existing insurance coverage.

Employee Benefits/Life - A class of insurance that generally includes personal life, annuity, health, and disability insurance, employer-sponsored fringe benefits, including life, accidental death, travel, medical, dental, disability, and retirement, and related actuarial and administrative services.

Endorsement - Documentary evidence of a change in an existing policy which may result in either an additional premium, a return premium, or no premium adjustment.

Exclusive Agent - An agent who represents a single insurer, has little or no ownership rights in the policies sold, and generally receives a lower rate of commission than the independent broker because the insurer performs services such as policy-writing, billing, and collecting.

Expiration Date - The date on which an insurance contract terminates.

Expirations - In a business combination, the value of future renewal commissions related to an acquired customer base or book of business.

Facultative Reinsurance - Arrangements under which each risk to be reinsured is offered to and is either accepted or rejected by the reinsurer. (See also Treaty Reinsurance.)

Fee in Lieu of Commission - A payment by a client to a broker in an amount agreed to between them in return for the broker's services relating to a client's insurance program.

Fees - Charges to clients in lieu of or in addition to commissions for placement of coverage or charges for services other than placement of coverage.

Fiduciary Funds - Funds collected and held by a broker from clients and underwriters until remitted to the other party.

Handler - The person responsible for placement or handling of a particular portion of an insured account.

Independent Agent - An agent who represents a number of underwriters, bills the policyholders, collects premiums, and generally is considered to own the renewal rights on the policies he or she has written. Most major stock insurance companies use independent agents.

Industry Class Code - A code used to identify commercial accounts as to kind of business. The numbers, which range from 1 to 99, are the United States Government's standard commercial classifications.

Installment Premiums - Premiums payable periodically rather than in a lump sum at the inception or effective date of the policy.

Insured or Assured - The person or entity in whose name the insurance policy is issued and whose life, property, or liability exposure is insured.

Invoice - A document forwarded to an insured reflecting premium or fees due.

Item Basis Payable ("IBP") - The procedure in which the broker defers payment to an insurance company on a given item until the client has paid the broker and the contract terms have expired. No legal liability to the broker can be incurred until those events occur.

Lifing Analysis - An analysis of the anticipated continuation of renewals related to a particular client base or book of business.

Long-Tail Business - A line of insurance for which losses are expected to continue to be reported and settled over a long period after the coverage term. Examples of long-tail business include medical malpractice insurance and many kinds of liability insurance.

Loss Ratios - Relationships between claims amounts and premiums. Two ratios commonly used are

- Paid loss ratio - paid claims divided by written premiums or earned premiums.
- Incurred loss ratio - incurred claims divided by earned premiums.

Managing General Agent ("MGA") - A person or organization that is authorized by an insurer to underwrite and bind risks on the insurer's behalf and who may perform other services in connection with the business written.

Marketing - Services by a broker related to negotiating and placing insurance coverage with an underwriter.

Mass Marketing or Mass Merchandising - The marketing of standardized personal lines insurance package to individual members of an association, organization, or employer. Insurance coverages are sold to members of an organization by first securing the endorsement of the sponsoring organization for a special program and then approaching each member with the organization's especially tailored policy.

Personal Lines - Coverage for persons rather than businesses. Personal lines include, for example, automobile and homeowners' insurance and individual life insurance.

Policy Period - The period for which a policy contract provides insurance.

Policy Year - The calendar year in which a policy became effective.

Premium - The money paid for insurance coverage.

Premium, Earned - See Earned Premium.

Premium Finance - Financing of premiums by a financial institution or insurance company.

Premium, Net - The amount of the premium due the underwriter after deduction of commission.

Premium Rate - The price per unit of insured exposure.

Premium Return - The premiums due to a policyholder on cancellation of a contract, for a rate adjustment on audit, or for a reduction of coverage.

Premium Taxes - Taxes levied by various states on premiums written by insurance companies.

Premium, Unearned - The portion of the premium for insurance in force that applies to the unexpired period of the policy term, usually determined on a pro rata basis.

Producer - The person responsible for bringing the insurance account to a broker. A producer may be one person or a team of persons responsible for initially producing the account. A single person may from time to time be a producer and an account executive.

Property - A class of insurance that covers loss of property or loss of use of property caused by fire and other perils, such as homeowners' insurance and commercial package policies.

Prospecting - Efforts by a broker to obtain new clients or new or renewal business from existing clients.

Reinsurance - Indemnification by an underwriter (called a reinsurer or assuming company) of all or part of a risk originally undertaken by another underwriter (called the reinsured or ceding company).

Reinsurance Intermediary - A middleman between underwriters in the transfer of insurance risks.

Remittance Advice - A bordereau transmittal form used in paying an underwriter for items due.

Renewal - Continuation of an insurance contract beyond the original date of expiration by endorsement, certificate, or a new contract.

Renewal Right - A right of a life insurance agent to continue to receive renewal commissions even though the relationship between the agent and the underwriter has terminated. In a business combination, renewal rights are tied to the value of future renewal commissions related to an acquired client base or book of business.

Reporting-Form Policy - Insurance coverage for which variable periodic premiums are charged based on predetermined rates applied to values that change throughout the policy period. The premiums for reporting-form policies generally are calculated, reported, and remitted by the insured to the broker, usually on a monthly basis.

Retail Broker - An intermediary between clients seeking insurance coverage and underwriters. Retail brokers include certain financial institutions, such as banks and securities brokers, that also are active in marketing certain kinds of insurance coverages.

Revenue Recognition Date - The date on which all of the following criteria are met: protection is afforded under the insurance policy, the premium due under the policy can be reasonably estimated, and the premium is billable to the client.

Rewrite - A new policy issued to replace one or more existing policies accompanied by a cancellation of the existing policies.

Risk Management - The coverage or protection achieved through a systematic combination of risk retention and risk transfer.

Run-Off - The eventual settlement of losses from a group of policies that occurs over a period of years following the expiration of the policies.

Self-Insurance - The portion of a risk to loss or liability that an entity retains, either voluntarily as part of a risk management program or involuntarily due to the unavailability of coverage at an acceptable price. Self-insurance may involve the setting aside, or the reserving, of funds by a person or organization to meet losses and accumulation of a fund to absorb fluctuations in the amount of loss, with the losses charged against the fund or reserve.

Treaty Reinsurance - Arrangements that provide for automatic reinsurance of an agreed portion of business written. Treaty reinsurance avoids the need for submitting each risk to the insurer for acceptance or rejection. (Also see Facultative Reinsurance.)

Underwriter - An entity that accepts an insurance risk from a policyholder in return for a premium.

Underwriting - The assumption of risk for designated loss or damage on consideration of receiving a premium; usually also considered to cover the determination as to the acceptability of risks to be insured and of the amount of premium to be charged.

Unearned Premium - The pro rata portion of the premium in force that applies to the unexpired period of the policy term.

Wholesale Broker - An intermediary between retail brokers and underwriters. Wholesale brokers include excess and surplus lines brokers and brokers that place insurance in international insurance markets, such as Lloyd's of London.

References are to appropriate paragraphs in the draft dated 5-3-89

Accounting By Insurance Agents and Brokers (File 3165.IA)

Mr. Kauth, Chairman of the Insurance Agents and Brokers Task Force, led a discussion of the task force's draft issues paper, "Accounting by Insurance Agents and Brokers." He stated that advisory conclusions have been added to the task force's paper since the last time AcSEC discussed it a year ago. The task force was formed because there was an absence of guidance in the accounting literature for insurance agents and brokers. Four of the largest public insurance brokers are represented on the task force, which unanimously agrees with the conclusions in the paper. The U.S. insurance brokerage community as well as their U.K. counterparts, also favor the paper.

Mr. Kauth said that not all conclusions in the paper are consistent with current accounting practice for the insurance agents and brokers industry. If the advisory conclusions in the paper were to become effective, all brokers would have to change one or more facets of their accounting for revenue recognition or financial statement presentation.

The majority of the paper deals with revenue and expense recognition for retail brokers who place commercial risks, such as property and liability coverage. The paper discusses other kinds of brokers, but the advisory conclusions presented for them are consistent with those described for retail brokers in paragraph 84 of the paper. The task force believes the conclusions in the paper provide a practical solution for accounting by insurance agents and brokers and believe that the paper should be published in one form or another. The paper has been restructured. Discussion and guidance on various revenue recognition issues is presented in paragraphs 31-36. Expense recognition issues are addressed in paragraphs 64-67.

Mr. Schuetze asked if the changes to practice caused by the advisory conclusions in the paper would be material. The task force members responded as follows:

- The main change would be in financial statements presentation.
- Expense recognition would not change.
- For large public brokerage firms there would be little change in revenue recognition practice. In this area the paper basically recommends what is current practice for those firms.

- Cash basis revenue recognition, which is prevalent in the industry for nonpublicly held firms, would be eliminated.

Mr. Schuetze asked if the paper had at one time contained advisory conclusions that would materially change practice by requiring a significant accrual of revenue. Mr. Kauth responded that the last time the task force met with AcSEC, the paper did not have advisory conclusions. The task force had previously requested that the Planning Subcommittee allow the paper to be presented to AcSEC without advisory conclusions. So the advisory conclusions originally in the paper were removed before the paper was presented to AcSEC for initial discussion at its December 1986 meeting.

Mr. Kauth said the original advisory conclusions that were removed from the paper differ from those now currently in the paper. The original advisory conclusions were derived from a conceptual point of view and recommended deferral of some of the policy service costs before the issuance of a policy and a provision for those costs that extend throughout the policy period or subsequent to the policy period. These conclusions have never been tried in practice or field tested, so there is no way to know whether they are practical.

At the December 1986 AcSEC meeting, the task force was asked to put advisory conclusions back into the paper. While doing that, the task force reviewed the basis for those conclusions and decided that until the area of accounting for service industries in general is acted on by the accounting authorities, the task force should simply recommend practices that are practical and likely to be durable, and not recommend substantial change.

Mr. Kenny said that the insurance broker industry is unusual because there are six thousand brokerages in the U.S. but only around eight of them are public companies. Unlike the savings and loan industry or the insurance industry itself, no regulatory authority, other than the tax authorities, require the brokers to produce financial statements, so their financial reporting is diverse.

The paper provides guidance to practitioners and bankers who become associated with the industry for the first time. Mr. Rosenfield said that for that reason, publication as a guide might be best.

Mr. Crooch asked if there is a practice problem in the industry, such as brokerages going bankrupt or a clamor from outside parties that they are being mislead by the brokers' current financial reporting. Mr. Kenny said there is no such problem but that there is an information gap, which the paper is trying to fill.

Many members of AcSEC agreed that the information in the paper should be made available to the AICPA membership in some form and discussed what kind of form it should take.

One proposal was to make the paper a descriptive guide of practice without advisory conclusions, such as the airline guide. Mr. Strauss said that even if descriptive, it would still have to present some accounting policies. Mr. Kauth said he believes that whatever its form, the paper should contain conclusions, because it deals with broad issues for the industry and without them, diversity of practice would continue.

Mr. Schuetze pointed out that accounting in the airline industry originated from a regulated environment and therefore had less diversity than the insurance agents and brokers industry. Mr. Ball said both the Airline Guide and the Casino Guide, though primarily descriptive, did label a couple of practices as not sound. Mr. Kauth said the task force's paper does recommend conclusions that differ from current practice, such as the financial statement presentation conclusions, and asked for further clarification on how to present the paper as a descriptive guide. Paragraph 72.

AcSEC discussed paragraphs 85 and 86 on revenue recognition and made the following comments:

- Consider eliminating one of the two revenue recognition methods. Paragraph 55.
- Issue one asks when revenue and expenses should be recognized in a retail insurance brokerage. The discussion following the question deals with only revenue and not expenses, but it should also deal with expenses. Separate discussions of revenue and expense recognition issues have been provided.
- If it is uncertain when a cost is to be incurred, normally the recognition of the related revenue is deferred until the cost is incurred, instead of accelerated as recommended in the paper, to achieve the matching of revenues and expenses. Only if the service cost is inconsequential could the method recommended in the paper be acceptable. Paragraph 67

- Paragraph 86 refers to a theoretical basis as opposed to the practical method that is recommended by the paper. There is no need to refer to a theoretical basis if that is not the method to be recommended. Delete the paragraph. Deleted.

- The paper needs additional arguments to better support its position of not accruing cost incurred to service the policy after the revenue recognition date. Paragraphs 67 and 85

- The rationale for current practice should be strengthened. Various revisions have been made throughout the paper.

AcSEC discussed paragraph 95 on the balance sheet and made the following comments:

- If the entity is only an agent for collecting the fiduciary cash, the cash is not an asset of that entity and should not be on the balance sheet.

- Remove the alternative accounting from the paper. The reporting of fiduciary cash and premiums due from clients should be required either in the balance sheet, in a note, or both, but not as a free choice.

- The fiduciary cash, if reported on the balance sheet, is not regular cash but restricted cash.

- The fiduciary cash, if reported on the balance sheet, should be shown on a separate line if required by law to be kept separate.

Paragraph 72

The task force said the fiduciary cash is often commingled with the company's own cash and cannot be separated dollar for dollar. The asset is not necessarily always in the form of cash. The company holds a receivable for a period of time before receiving cash. The broker has the risk of collecting the receivable and is liable to the underwriter for it. The task force therefore believes it is better to present both the receivable and the payable to the underwriter on the balance sheet rather than netting them. As to the broker, because it is allowed to earn interest income on the cash it collects to remit to the underwriter, that interest is a part of its total compensation. If it was not allowed to earn that interest income, higher commission rates would be charged.

Mr. Strauss said the section on business combinations deals with issues that do not apply specifically to brokers and interprets general provisions of APB Opinion 16. He believes the section should therefore be deleted. Any kind of company could have those kinds of transactions, not just brokers. Mr. Schuetze agreed.

Mr. Kauth said the task force did not intend for the section to provide accounting guidance on business combinations but rather to operate as a checklist for helping companies determine what they were selling. He said he prefers to revise the chapter rather than delete it.

Members of AcSEC made the following comments about the section of the paper on business combinations:

- Pages 84 and 85 list two methods for determining goodwill, but only one of them is permitted by APB Opinion 16. Paragraphs 143 and 159
- Paragraph 195 on page 78 refers to a FASB discussion memorandum on business combinations. It should instead refer to APB Opinion 16. Paragraph 151

Mr. Strauss proposed that the paper be redrafted, though the specific kind of document is not yet decided, to include the arguments in the discussion expressed by the task force that AcSEC believes are not clearly expressed in the current draft of the paper and to provide conclusions. Mr. Kauth said the task force will revise the document and address the revenue recognition alternatives as well as the overall format of the paper.

Mr. Schuetze encouraged the task force to keep in mind when it rewrites the paper that the FASB will have to review it and that some FASB members do not like "either...or" kind of language.

AcSEC discussed that if the document is to be a guide, whether it should also contain auditing guidance. Mr. Kauth said that audit guidance could be developed by the task force, but it would prefer not to include auditing matters. Once someone understands the industry, through the descriptive guidance in the paper, the auditing would not be difficult, because it involves the same auditing knowledge as any other service industry.