CloserLook
The power of strong financial reporting as InsurTech startups mature
Overview

Only a few years ago, InsurTech occupied a small corner in the FinTech sector, but thanks to the growth of digital technology and the rapid pace of innovation, it has blossomed into a thriving industry. Indeed, the InsurTech sector saw the arrival of its first private company with a billion-dollar valuation, an online auto insurer that through telematics allows applicants to link their premium to their driving performance.¹

Investor interest in InsurTech today is strong. A recent report by the Deloitte Center for Financial Services² noted investment in the sector reached $870 million through the first half of 2018, putting it on pace to at least meet the $1.82 billion raised last year, which was the industry’s second-highest level of financing (see figure 1).

Figure 1. InsurTech investments on track to at least match 2017

InsurTech funding by category in $M

Source: Venture Scanner data, Deloitte Center for Financial Services analysis.

And while many InsurTech companies are currently small compared to established giants in the insurance sector, they are growing quickly. Such rapid growth often brings financial and operating challenges, and it is important for companies to address them in order to sustain their success over the long term.

In the remainder of this article, we will explore some key accounting and financial reporting considerations for challenges commonly encountered by startups.
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Accounting considerations

From our work with InsurTech clients, we have seen several accounting-related challenges emerge. InsurTech startups provide financial information to their investors on a regular basis, but certain aspects may not conform to generally accepted accounting principles in the United States of America (US GAAP). Getting the accounting right is important for giving a fair picture of the company’s financial condition, and it will likely lay the groundwork for raising debt or equity capital in the future—a process that requires financial statements that conform to generally accepted accounting principles.

Three specific areas of consideration relate to revenue recognition, the valuation of the company’s common stock and warrants issued, and accounting for internal-use capitalized software:

• **Revenue recognition.** On May 28, 2014, a new accounting standard was issued by the Financial Accounting Standards Board (FASB) on revenue from contracts with customers. The standard, ASC 606, *Revenue from Contracts with Customers*, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers, and it supersedes most current revenue recognition guidance, including industry-specific guidance. Insurance contracts as defined under ASC 944, *Financial Services—Insurance*, are outside the scope of the new standard. Insurance entities that render other services, however, will need to apply ASC 606 and have a clear understanding of the performance obligations associated with each customer contract in order to determine when the obligation has been satisfied and the appropriate amount of revenue to be recorded to the income statement. In many cases, there may be more than one performance obligation associated with a contract, which could add an additional layer of complexity to how or when revenue is recognized.

InsurTech companies should have a financial reporting team with expertise in this area or seek accounting advice as soon as possible on the impact of the new standard, which is effective for nonpublic companies for annual reporting periods beginning after December 15, 2018.

Note: As stated above, entities that issue insurance contracts as defined in ASC 944 should continue to follow the revenue recognition guidance therein to account for those contracts. Also refer to Deloitte’s August 2018 Insurance Spotlight publication, which discusses new guidance issued to amend the accounting model for certain long-duration insurance contracts.
*Valuation.* Determining the company's valuation is a key issue for startups. It is critical for raising capital and for attracting and retaining employees, who can have a significant investment in the company.

Third-party specialists are generally hired to perform a 409A valuation, and companies should ensure the assumptions used in the valuation are appropriate and reasonable. The 409A valuation is important for tax purposes, and it is used in determining the value of share-based compensation awards.

The 409A valuation would also be used for the valuation of warrants issued by the company. Additional consideration should be given to whether the terms associated with those warrants result in the warrants being classified as equity or debt instruments in accordance with US GAAP. The classification determination involves significant judgment and would have different outcomes on the company's financial position and results year over year.

*Capitalized software.* Under US GAAP, costs associated with internal-use software should be capitalized when certain criteria are met. Many InsurTech companies are building proprietary systems and may not realize that they can capitalize certain costs on the balance sheet and amortize the amounts into the income statement as an expense over time. In many cases, startups record the costs immediately as an operating expense, which can distort the company's financial results given the longer-term use of the software.

As an early-stage InsurTech startup matures, the demand for complete financial information in accordance with US GAAP grows, and taking early action is important. If accounting issues are not identified early and are unresolved for an extended period, they may be more difficult to address in the future.

**Tax considerations**

In addition to tax compliance considerations, companies also contend with several operational tax considerations. Key areas of focus include:

- Strategic tax planning
- Impact of tax reform passed in 2017
- Federal and state credits and incentives
- Research and development credits
- International tax structuring
- Transaction planning
- Indirect taxes, such as sales and use tax and value-added tax (VAT)
- Compensation, benefits, and equity planning

It's important to have a tax adviser who can advise on issues and opportunities specific to the InsurTech startup and provide the business insights needed to expand business, explore new markets, and enhance stakeholder value.
Information security considerations

Given how rapidly cybersecurity threats emerge and change, key jurisdictions have issued regulations related to cyber integrity requirements. InsurTechs may not be aware of the extensive work necessary to meet these standards, could be behind on the compliance maturity curve, and may need to do more work to catch up. InsurTech companies will need to continually sharpen their focus on data security and compliance, particularly as they expand their business across borders.

For example, at the state level, the New York Department of Financial Services (NYDFS) issued a cybersecurity regulation (23 NYCRR 500) that requires NYDFS-regulated entities to establish a cybersecurity program that includes conducting a risk assessment, adopting a written cybersecurity policy, and designating a chief information security officer, who must report to the company's board at least biannually to provide an assessment of the information systems.

Other cyber regulations or frameworks that have been issued recently include the National Association of Insurance Commissioners' data security model law (which is largely based on the NYDFS regulation); California's Consumer Privacy Act; the European privacy regulation, General Data Protection Regulation (GDPR); the Securities and Exchange Commission's enhanced guidance and recent investigative report (which focuses on cyber disclosure obligations, insider trading policies and procedures, board oversight, and internal accounting controls); and the American Institute of Certified Public Accountants' cybersecurity attestation-reporting framework.

Exit strategy considerations

Despite the challenging regulatory landscape, the InsurTech ecosystem is healthy and active, with multiple sources of capital, a deep roster of experienced advisers, and a mix of startups and incumbent players. The sector also has rising levels of capital investment, an open pathway to initial public offerings (IPOs), and a robust climate for mergers & acquisitions (M&A) dealmaking—all of which suggest a strong future for the sector.

While the pathway is open, the market for IPOs is complex and challenging. For companies considering a possible IPO, it’s important for senior executives and members of the board to prepare for the transition to public ownership. Companies generally engage experts to mitigate transaction risk and compress execution timelines. As InsurTechs mature, choosing to act as a public company may yield tangible financial value regardless of whether or not there is an IPO in the works. The preparation that goes into public ownership provides a strong foundation for managing a company well and may produce the benefits of an effective and efficient finance function, improved decision-making support, value-driving internal controls, and risk mitigation. This preparation can also be beneficial in the quality of earnings analysis performed as part of M&A financial due diligence procedures carried out by a potential buyer.
Stay ahead of the curve

Get in touch with a member of our InsurTech Audit & Assurance leadership team to discuss these accounting and financial reporting considerations to learn how Deloitte may be able to assist you:

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**Endnotes**


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