



IASB/FASB Meeting
4 May 2011

IASB
Agenda
reference **1D**

Staff Paper

FASB
Agenda
reference **66D**

Project	Insurance contracts
Topic	Unbundling goods and services

What is this paper about?

1. The purpose of this paper is to ask the boards to decide whether goods and services provided in an insurance contract should be separated and measured in accordance with the proposed revenue recognition model.
2. Agenda paper 1C/66C provides supporting material for this paper.

Staff recommendation

3. We recommend that goods and services should be unbundled from an insurance contract in accordance with the principles on identifying separate performance obligations in the revenue recognition project (Alternative C). Once separated those goods and services would be measured in accordance with relevant requirements of IFRSs and US GAAP.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

IASB/FASB Staff paper

Staff analysis and recommendation

Alternatives

4. We believe that the boards have the following viable alternatives:
- (a) require that the obligation to provide non-insurance services or goods should be unbundled *only* if they have been combined in a contract with the insurance coverage for reasons that have no commercial substance (which we are calling ‘*Alternative A*’).
 - (b) require further unbundling of non-insurance services and goods (in addition to those combined for reasons that have no commercial substance in Alternative A). This could be achieved in two ways:
 - (i) provide further guidance on how to apply the ‘closely related’ principle to insurance contracts by including further examples of services and goods that are considered closely related, or not closely related, to the insurance coverage (which we are calling ‘*Alternative B*’).
 - (ii) require insurers to unbundle insurance contracts using the criteria developed in the revenue recognition project for identifying separate performance obligations (which we are calling ‘*Alternative C*’).
5. We think the other criteria suggested by respondents¹ described in paragraph 26 in Agenda paper 1C/66C should not be explored. Those criteria may result in inconsistencies with the forthcoming separation guidance in IFRS/US GAAP on identifying separate performance obligations in a single contract. Such inconsistencies increase complexity and reduce comparability. In addition, one of the criterion suggested, ie when components are not interdependent, was not

¹ ie, when practicable, when the components can be measured separately and are managed separately, when components are not interdependent, or when the revenues are readily identifiable.

IASB/FASB Staff paper

supported by the boards in their deliberations pre-ED/DP because of concerns about operationality.

Alternative A—confirm the ED/DP

6. The feedback received generally supported the proposal that unbundling should be required for goods and services that have been combined with insurance coverage for reasons without commercial substance. Feedback was mixed on whether that should be the only criterion, or whether further unbundling should be required. Feedback indicated that some were confused with the application of ‘closely related’ and some asked whether and how the bifurcation guidance on the ‘closely related’ embedded derivatives should be analogized to other situations that include goods and services.
7. The boards could confirm that only goods and services that have been combined with insurance coverage for reasons without commercial substance should be unbundled but, as discussed in paragraphs 8, we think that further unbundling should be required. If the boards decide on this alternative, we recommend deleting ‘closely related’ because it caused confusion (discussed in agenda paper 1C/66C).

Alternative B or C—require further unbundling

8. Most goods and services are bundled with insurance coverage for valid commercial reasons. As outlined previously, many respondents agree with the boards that goods or services that have been combined with a contract for reasons lacking commercial substance should be unbundled. In some cases we believe that, when the goods or services have been combined with insurance coverage for valid commercial reasons, the provision of such goods or services by the insurer can introduce additional elements of risks that should also be presented separately. In addition, separating those goods and services provides useful information on the profit drivers of those contracts. For example:

IASB/FASB Staff paper

- (a) The revenues and expenses from those separated goods and services will be presented gross in the profit and loss statement and will be recognised as arising from those goods and services instead of being included in the underwriting margin. The profit and loss statement of the insurers will be more comparable to other entities. Under the building block model the gain (or loss) is subsumed in the residual/composite margin.
 - (b) The building block and revenue recognition models recognise identical net profit/loss attributable to those goods and services over the life of the contract. However, they differ in the timing of recognition of the net profit. The magnitude of this difference depends on the pattern of allocation of the residual/composite margin to profit and loss, and the treatment of acquisition costs. For example, consider an asset management component with a fee (eg net of expenses of 0.5 per cent). Under the proposed building block model, the liability on inception will include the expected present value of all the future amounts of the 0.5 per cent asset management fee calculated on an account balance. This will result in a larger residual/composite margin than if that fee (less expense) were unbundled and excluded from the measurement of the insurance liability. Suppose there is then a change in estimates of persistency. The expected present value of future asset management fees less expenses will change, leading to a gain or loss in the period of the change and reported as a change in estimates².
9. There are two ways by which the boards could require that insurance contracts be assessed so that goods and services components other than just those lacking commercial substance would be unbundled. These are discussed below.

² We will consider in a future meeting the treatment of changes in estimates if the residual/composite margin is unlocked.

IASB/FASB Staff paper

Alternative B—provide more examples

10. The boards could develop further examples of goods and services that are not closely related and so should be unbundled (and those that are closely related and so not unbundled) from insurance contracts. A ‘closely related’ criterion would be consistent with current separation requirements for embedded derivatives. The starting point for those examples could be the questions that were commonly received during outreach, field tests and comment letters.
11. We do not recommend this alternative, because it is a rule-based solution and might result in the same drawbacks and criticisms as the current ‘closely related’ bifurcation requirement for embedded derivatives.³ In addition, it would add to complexity by creating another interpretation of ‘closely related’, located in a different place than for financial instruments.

Alternative C—Use revenue recognition model

12. If the boards are to require *further* unbundling of goods and services from insurance contracts, a natural alternative would be to apply the principles developed in the revenue recognition project for identifying separate performance obligations in a contract with a customer. We think that comparability of the financial performance of insurers with non-insurers is enhanced if both apply the same principles, ie those developed in the revenue recognition project.
13. At the recent February 2011 joint meeting on revenue recognition, the boards tentatively decided that:
 - (a) An entity should account for a bundle of promised goods or services as *one performance obligation* if the entity provides a service of integrating those goods or services into a single item that the entity provides to the

³ IFRS 9 *Financial Instruments* paragraph 4.4.3 states that the ‘the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host’. A series of examples then illustrates this. The FASB defined the term similarly in SFAS 133 *Accounting for Derivatives and Hedging Activities*. The FASB then provided a series of illustrative examples that were identified as Derivatives Implementation Issues which have since been codified.

IASB/FASB Staff paper

customer. (If this criterion is satisfied, the entity need not consider the criteria in (b)).

- (b) An entity should account for a promised good or service as *a separate performance obligation* if:
- (i) the pattern of transfer of the good or service is different from the pattern of transfer of other promised goods or services in the contract, and
 - (ii) the good or service has a distinct function.

A good or service has a distinct function if either:

- (i) the entity regularly sells the good or service separately, or
- (ii) the customer can use the good or service either on its own or together with resources that are readily available to the customer.

(The wording of the above decision may change when drafted in the final standard.)

14. We think that, where possible, the same principles that apply for revenue recognition should also apply to the unbundling of non-insurance goods and services because in both cases the entity is determining when to separate performance obligations in contracts. Appendix A shows our analysis of the application of those principles to some examples of insurance contracts combined with services and goods. We believe that the application of those principles results in useful information because it provides more transparency on the profit drivers for insurers in a way consistent with the revenue recognition project. We believe that these benefits outweigh the costs of unbundling (discussed in agenda paper 1C/66C). The principles would unbundle only specified goods and services that are distinct from the provision of insurance coverage.
15. If the boards agree that goods and services should be separated from an insurance contract in accordance with the criteria being developed in the revenue recognition project, it would be logical to also measure the distinct goods and services in

IASB/FASB Staff paper

accordance with the measurement requirements developed in the revenue recognition proposals. At present, the boards have not finished discussing the measurement requirements in the revenue recognition proposals. We intend to consider those requirements and all the unbundling decisions as a whole, and if necessary, will bring back any relevant issues.

16. In addition, further application guidance or illustrative examples may be necessary to illustrate how those principles will be applied to insurance contracts.

Question 1—unbundling goods and services

Do the boards agree that goods and services should be separated from an insurance contract in accordance with the principles on identifying separate performance obligations in the revenue recognition project (Alternative C)?

Do the boards agree that, once separated, those goods and services would be accounted for in accordance with relevant requirements under IFRS and US GAAP?

IASB/FASB Staff paper

Appendix A: Applying the tentative decisions on separating performance obligations to insurance contracts

Examples	Applying the tentative decisions in the revenue recognition project
<p>Example 1</p> <p>A unit-linked insurance contract has the following terms:</p> <p>(a) The contract is for a fixed term or until the death of the policyholder, whichever occurs earlier.</p> <p>(b) In the first 2 years, the policyholder is required to pay a fixed premium amount. The premium can be paid annually, quarterly or monthly.</p> <p>(c) After year 2, the policyholder has the flexibility to cease paying the premium amounts or to vary the premium amounts.</p> <p>(d) The premiums purchase a number of units in an investment fund depending on the unit values. The investment fund is a mix of bonds and equity investments.</p>	<p><i>Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?</i></p> <p>No, because the stand-ready obligation for the life insurance and the asset management services are unrelated. They are managed separately.</p> <p><i>Is the pattern of transfer different?</i></p> <p>Yes, the mortality risk is higher towards the end of the contract and the asset management services occur evenly during the life of the contract.</p> <p><i>Are they distinct?</i></p> <p>Yes, the policyholder can benefit from the investment in the fund separately from the life insurance cover. This is because (a) the policyholder benefits from life cover irrespective of the amount invested in the fund; and (b) the policyholder receives a return from being exposed to the investment risk that is unrelated to the life insurance cover.</p>

IASB/FASB Staff paper

Examples	Applying the tentative decisions in the revenue recognition project
<p>(e) On death, the beneficiaries receive a sum assured of CU100,000 plus the value of the units (without any surrender charges).</p> <p>(f) Monthly charges are deducted from the investment fund to pay for the cost of insurance⁴ and expenses (eg asset management expenses).</p> <p>(g) The policyholder can withdraw at any time. An exit fee (calculated as a percentage of the value of the units surrendered) is charged if the policyholder surrenders the contract before the fixed term of two years has finished. On surrender of the whole contract, no surrender value is paid out in relation to the forfeited death benefit component.</p>	<p>Result: the asset management fees are separated from the insurance contract.</p>

⁴ Sometimes termed ‘mortality and expense risk fees’.

IASB/FASB Staff paper

Examples	Applying the tentative decisions in the revenue recognition project
<p>Example 2</p> <p>The same contract as in example 3 except that for (e), the sum paid out to beneficiaries is the higher of the value of the invested units (without any surrender charges) and CU100,000. Thus, on death, the insurer is on risk for the difference between CU100,000 and the value of the invested units, assuming that the value of the units is below CU100,000.</p>	<p><i>Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?</i></p> <p>Yes, the facts in this example suggest that the insurer is providing the policyholder with a product that integrates insurance features with investment features. Providing the policyholder with this integrated product is different from providing the customer with a separate insurance contract and investment fund because mortality risk is a factor of both the value of the investment fund and the probability of death.</p> <p>Result: the asset management fees are not separated</p>

IASB/FASB Staff paper

Examples	Applying the tentative decisions in the revenue recognition project
<p>Example 3</p> <p>A contract for a sale of a car with ‘free’ 3-year non-cancellable motor accident insurance.</p> <p><i>(This example has been previously brought up in board meetings by a board member.)</i></p>	<p><i>Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?</i></p> <p>No, because the car and the insurance coverage are not interrelated and the entity is not providing a service by integrating the car with the insurance. The sale of the car is not highly interrelated to the provision of the motor accident coverage. The motor accident insurance is a ‘sweetener’ to promote the sale of the car.</p> <p><i>Is the pattern of transfer different?</i></p> <p>Yes, the control of the car is transferred to the customer on the date of the sale and the entity has a stand-ready obligation over the three years for the motor accident insurance.</p> <p><i>Are they distinct?</i></p> <p>Yes, because the customer can use the car without the motor accident insurance. Even if the insurance is a legal requirement, the customer could buy the insurance from another provider. Thus, the car is distinct from the insurance.</p> <p>Result: The sale of the car is unbundled from the insurance contract. The sale of the car is accounted for under the revenue standard and the insurance coverage is accounted for under the insurance requirements.</p>

IASB/FASB Staff paper

Examples	Applying the tentative decisions in the revenue recognition project
<p>Example 4</p> <p>An insurer may sell claims processing services on a stand-alone basis to a customer and might sell those services bundled with a stop-loss insurance contract.</p> <p>Stop-loss insurance is offered by primary insurers to protect employers that self-fund their employee benefit plans. To provide financial protection against catastrophic claims, some self-funding employers purchase stop-loss insurance from insurers.</p> <p>Specific stop-loss insurance is provided to set a limit on the employer’s burden for medical expenses for each covered individual. Aggregate stop-loss insurance may also be provided to limit overall annual costs for a self-funded plan by addressing the accumulation of expenses on all individuals.</p> <p>Should the payment processing services be separated from the stop-loss insurance contract when those are part of the same contract?</p> <p><i>We will consider in a future paper whether contracts should be combined. We intend to discuss in that paper</i></p>	<p><i>Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?</i></p> <p>No, because the provision (or non-provision) of the claims processing services that is under the excess amount is unrelated to the provision of stop-loss insurance. While the insurer can minimise its risk by providing the claims processing services, the insurer is primarily providing the claims processing services because it is contracted to do so. The entity is self-insuring for the amount below the amount insured under the stop-loss insurance contract and has contracted the insurer to provide the claims processing service for all claims because the insurer can provide that service more cheaply.</p> <p><i>Is the pattern of transfer different?</i></p> <p>That depends on the type of stop-loss contract issued. The pattern of insurance risk is assessed at the coverage level.</p> <p>If it is an aggregate stop-loss insurance contract (ie when the accumulated claims exceed a specified amount), the risk of that occurring increases more than proportionately over time. This pattern of transfer is different from the provision of the claims processing services, which occurs evenly over the life of the contract.</p>

IASB/FASB Staff paper

Examples	Applying the tentative decisions in the revenue recognition project
<p><i>whether a stand-alone claims processing services contract should be bundled together with the stop-loss insurance contract.</i></p>	<p>If it is a specific stop-loss insurance contract (eg the single instance in which the policyholder’s cumulative paid benefits exceed the defined threshold) the risk is likely to occur evenly over the period. In this circumstance, the pattern of transfer of the stand-ready obligation is similar to the pattern of transfer of the provision of the claims processing services.</p> <p><i>Are they distinct?</i></p> <p>Yes. The entity sells stop-loss insurance contracts or payment processing services in stand-alone contracts.</p> <p>Result: depending upon the type of stop-loss insurance coverage.</p>

IASB/FASB Staff paper

Examples	Applying the tentative decisions in the revenue recognition project
<p><i>Example 5—fully-insured health insurance contract with variable claim pattern</i></p> <p>An insurer contracts with a government agency (the ‘policyholder’) to provide specified benefits to a prescribed population of individuals. Based on the benefit design (structured as initial coverage with a limit, then a gap in coverage, and then catastrophic coverage limits) the expected pattern of claim varies throughout the year with higher claims expected early in the year, lower in the middle, and higher again at the end of the year. Although the contract is with the policyholder on a group basis, coverage levels are based on individual claim occurrences. In addition to the provision of insurance coverage, the contract stipulates that the insurer will provide administrative services to the policyholder, including claims processing and adjudication services.⁵ Similar administrative services are sold separately; however, the insurer does not sell this insurance coverage without the related administrative services. Service components are</p>	<p><i>Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?</i></p> <p>No, for the following reasons:</p> <ul style="list-style-type: none"> (a) The risks involved in providing the administrative services (eg the number of claims might be excessive and therefore costly) are entirely different from the risks involved in providing the insurance coverage (ie participants may submit claims for amounts in excess of those that the insurer anticipated). (b) The provision of claims processing services that falls during the period during which the policyholder is responsible for payment is unrelated to the provision of insurance coverage. While the insurer can minimise its insurance risk by managing the contract and providing the claims processing services, the insurer is primarily providing the claims processing services because it is contracted to do so. <p><i>Is the pattern of transfer different?</i></p> <p>No, provision of the administrative services and the insurance coverage</p>

⁵ Claims adjudication is the determination of the insurer's payment or financial responsibility, after the member's insurance benefits are applied to a medical claim.

IASB/FASB Staff paper

Examples	Applying the tentative decisions in the revenue recognition project
<p>generally provided ratably (ie evenly) throughout the year.</p>	<p>are both transferred to the policyholder evenly over the length of the contract. The pattern of insurance risk is assessed at the level of the individual because the coverage is at the individual level. Despite the fact that individual participants are forced to pay out of pocket during the gap in coverage, the insurer is at no point relieved of its insurance risk. Even during the gap period, a single large claim could trigger an obligation to resume funding claims.</p> <p><i>Are the goods and services distinct?</i></p> <p>Yes, the insurer sells administrative services as a stand-alone product.</p> <p>Result: Do not unbundle.</p>

IASB/FASB Staff paper

Examples	Applying the tentative decisions in the revenue recognition project
<p><i>Example 6—high-excess/deductible health insurance plan</i></p> <p>Contracts are sold both to individuals and to groups, generally with an annual term (assume this to be the calendar year). Under the contracts, the policyholder is responsible for 100 per cent of the costs at the beginning of the contract period up to a defined threshold (eg a CU2,000 excess/deductible). For high-excess plans sold as part of a group contract, the individual policyholders often have a choice of what coverage and what excess they can select. After the excess is met, the contract converts into a regular co-insurance arrangement whereby the insurer is responsible for 80 per cent and the policyholder is responsible for 20 per cent until the policyholder reaches an annual out-of-pocket maximum of CU6,000, at which point the insurer is responsible for 100 per cent. The insurer also provides administrative services to the policyholder for the entire duration of the contract, which includes claims processing services and network access. These services are generally provided evenly throughout the year.</p>	<p><i>Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?</i></p> <p>No, for same reasons as those noted in example 5.</p> <p><i>Is the pattern of transfer different?</i></p> <p>No, provision of the administrative services and the insurance coverage are both transferred to the policyholder evenly over the length of the contract. The pattern of insurance risk is assessed at the level of the individual because the coverage is at the individual level. Despite the fact that individual policyholders are forced to pay out of pocket prior to meeting the amount of their excess/deductible, the insurer is at no point relieved of most of its insurance risk. Even during the period before policyholders meet the amount of their excess, a single large claim could trigger an obligation to resume funding claims.</p> <p><i>Are the goods and services distinct?</i></p> <p>Yes, the insurer sells administrative services as a stand-alone product.</p> <p>Result: Do not unbundle.</p>

IASB/FASB Staff paper

Examples	Applying the tentative decisions in the revenue recognition project
<p>Example 7</p> <p>An insurer issues a term life insurance contract for a single premium of CU300 for a period of 5 years. If the policyholder dies during that period, the beneficiary receives a death benefit of CU25,000. An insurer has a claims processing department to process of the claims received and a team of asset managers to manage its investments.</p>	<p><i>Are the goods or services highly interrelated with the insurance coverage and is the entity providing a service of integrating those goods and services with the insurance coverage?</i></p> <p>The claims processing services and asset management are part of the normal operating activities or internal process of an insurer. The contract promises a benefit on death. The process that the insurer follows to make that payment is an internal process/activity and not a service to the policyholder. Because of that the insurer does not need to consider whether the claims processing services or its asset management is a separate performance obligation.</p> <p>Result: Do not unbundle.</p>