

# STAFF PAPER

**27 February – 29 February 2012**

FASB | IASB Meeting

Also to be discussed at FASB Education  
Session on February 8, 2012

Project	Insurance Contracts		
Paper topic	Unbundling- Goods and Services		
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## What is the purpose of this paper?

1. At the 4 May 2011 joint board meeting, the boards tentatively decided that goods and services should be unbundled from an insurance contract in accordance with the guidance for identifying separate performance obligations in the revenue recognition project and that unbundled goods and services should be accounted for in accordance with whichever guidance is relevant based on the characteristics of the unbundled component. The purpose of this paper is to:
  - (a) Determine how to incorporate the criteria for identifying separate performance obligations from the revenue recognition project into the insurance contracts project so that they can be used to unbundle goods/services components of insurance contracts
  - (b) Demonstrate how such guidance would be applied in unbundling goods/services components of insurance contracts (see appendix A)
  
2. The recommendations in this paper do not contemplate potential unbundling of asset management services that are provided as part of account-driven contracts. The staff plans to revisit that topic in a future paper about unbundling and/or disaggregating investment components.

**Staff Recommendation**

3. The unbundling criteria for unbundling goods and services should read as follows:
- (a) An insurer shall identify whether any promises to provide goods or services in an insurance contract would be performance obligations as defined in the Exposure Draft *Revenue from Contracts with Customers*. If a performance obligation to provide goods or services is distinct, an insurer shall apply the applicable IFRSs or U.S. GAAP in accounting for that performance obligation.
  - (b) A performance obligation is a promise in a contract with a policyholder to transfer a good or service to the policyholder. Performance obligations include promises that are implied by an insurer's customary business practices, published policies, or specific statements if those promises create a valid expectation of the policyholder that the insurer will transfer a good or service. Performance obligations do not include activities that an insurer must undertake to fulfil a contract unless the insurer transfers a good or service to a policyholder as those activities occur. For example, an insurer may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the policyholder as the services are performed. Hence, those promised setup activities are not a performance obligation.
  - (c) Except as specified in paragraph 3(d), a good or service is distinct if either of the following criteria is met:
    - (i) The insurer regularly sells the good or service separately.
    - (ii) The policyholder can benefit from the good or service either on its own or together with other resources that are readily available to the policyholder. Readily available resources are goods or services that are sold separately (by the insurer or another entity), or resources that the policyholder already has obtained (from the insurer or from other transactions or events).

- (d) Notwithstanding the requirements in paragraph 3(c), a good or service in an insurance contract is not distinct and, therefore, the insurer shall account for the good or service together with the insurance component under the insurance contracts standard if both of the following criteria are met:
- (i) The good or service is highly interrelated with the insurance component and transferring them to the policyholder requires the insurer also to provide a significant service of integrating the good or service into the combined insurance contract the insurer has entered into with the policyholder.
  - (ii) The good or service is significantly modified or customized in order to fulfil the contract.

## Background

4. As a reminder, the objective of unbundling is to account for a component of an insurance contract in the same way as for stand-alone contracts with characteristics similar to those of the unbundled component (ie a good/service component that is unbundled should be accounted for under the revenue recognition project).
5. If a component of a contract were unbundled, an insurer would have to determine how to allocate the contract's cash flows between the unbundled component and the remaining insurance component. In some situations, it would be easy to determine to which component a stream of cash flows belongs. In other situations, the cash flows might relate to more than one component. For this reason, there would be complexities associated with unbundling an insurance contract and accounting for a good/service component separately. These complexities should be considered in deciding whether the benefit of unbundling some components outweighs the related costs.
6. It is important to note that a determination by an insurer that it should separate a goods/services component from an insurance contract will have different

ramifications than a similar determination under the revenue recognition project. A determination to unbundle a good/service component from an insurance contract means that component will be accounted for under entirely different guidance (ie revenue recognition guidance); whereas separation of a performance obligation under the revenue recognition project means only that such a performance obligation should be accounted for differently in the context of the same guidance. As discussed in paper 4A/74A from the 20 October 2011 joint board meeting, the impact on an insurer's financial statements of accounting for a component would generally be comparable under each project except for as follows:<sup>1</sup>

- (a) Under the insurance contracts project, an insurer would have to estimate initially and at each subsequent reporting date the expected net cashflows for its contracts, whereas under the revenue recognition project estimates of expected cashflows would be remeasured only for specified features (eg for changes in estimates of variable consideration) and in specified circumstances (eg if a performance obligation is deemed onerous).
- (b) Under the insurance contracts project, the difference between the expected cash inflows and outflows would be recognized initially as the residual or single margin for the IASB and FASB, respectively. Based on the FASB's tentative decisions, the expected net cash flows would be updated at each reporting date and any changes would be recognized in the statement of comprehensive income. The IASB has tentatively decided that changes to the expected cash flows would offset the residual margin until it is exhausted, after which such changes would be recognized in the statement of comprehensive income.
- (c) Under the insurance contracts project, time value of money would be reflected using a discount rate that is consistent with the characteristics of

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<sup>1</sup> The analysis below discusses differences between accounting for contracts using the revenue recognition proposals and using the building blocks approach. For the premium allocation approach, there is no requirement to re-estimate expected cash flows in the liability for remaining coverage, unless the contract is onerous. If the effect of the time value of money and amount of acquisition costs are not significant, the measurement of a contract under the premium allocation approach rather than the revenue recognition approach may not lead to materially different reported net profit. However, differences would remain in that unbundling goods and services would reduce the amount of premiums reported for the insurance component and would lead to further disaggregated reported amounts on the face of the profit or loss.

the insurance liability. Under the revenue recognition project, an entity would use a discount rate consistent with the rate the entity would use in a separate financing transaction with its customers at inception.

- (d) Under the insurance contracts project, all acquisition costs (for FASB, only those related to successful efforts) incurred in originating contracts within a portfolio would be included in the initial measurement of the insurance contract liability. Under the revenue recognition project, an entity would recognize as an asset and systematically amortize incremental costs of obtaining a contract.
- (e) Under the insurance contracts project, an insurer would make disclosures specific to the type of insurance contracts it issues. Under the revenue recognition project, an entity would make disclosures that are not specific to any contract or type of contract.

### Staff Analysis

7. The following illustration shows the staff's proposed changes to the wording for identifying separate performance obligations in the exposure draft *Revenue from Contracts with Customers*. The analysis that follows explains the staff's reasoning for the changes. Added text is shown in bold, deleted text is struck through. The clean revised text is set out in paragraph 3.

#### Mark-up of Proposed Guidance from Revenue Recognition Exposure Draft

23. **An insurer shall identify whether any promises to provide goods or services in an insurance contract would be performance obligations as defined in the Exposure Draft *Revenue from Contracts with Customers*. If a performance obligation to provide goods or services is distinct, an insurer shall apply the applicable IFRSs or U.S. GAAP in accounting for that performance obligation.** ~~An entity shall evaluate the goods or services promised in a contract and shall identify which goods or services (or which bundles of goods or services) are distinct and, hence, that the entity shall account for as a separate performance obligation.~~
24. A performance obligation is a promise in a contract with a **policyholder customer** to transfer a good or service to the **policyholder customer**. Performance obligations include promises that are implied by an **insurer's entity's** customary business practices, published policies, or specific statements if those promises create a valid expectation of the **policyholder customer** that the **insurer entity** will transfer a good or service.

25. Performance obligations do not include activities that an **insurer entity** must undertake to fulfil a contract unless the **insurer entity** transfers a good or service to a **policyholder customer** as those activities occur. For example, an **insurer services provider** may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the **policyholder customer** as the tasks are performed. Hence, those promised setup activities are not a performance obligation.
26. ~~Depending on the contract, promised goods or services may include, but are not limited to, the following:~~  
~~Goods produced by an entity for sale, goods purchased by an entity for resale, etc...~~
27. ~~If an entity promises to transfer more than one good or service, the entity shall account for such promised goods or services as a separate performance obligation only if it is distinct. If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until the entity identifies a bundle of goods or services that is distinct. In some cases, that would result in an entity accounting for all the goods or services promised in a contract as a single performance obligation.~~
28. Except as specified in paragraph 29, a good or service is distinct if either of the following criteria is met:
- The **insurer entity** regularly sells the good or service separately.
  - The **policyholder customer** can benefit from the good or service either on its own or together with other resources that are readily available to the **policyholder customer**. Readily available resources are goods or services that are sold separately (by the **insurer entity** or by another entity), or resources that the **policyholder customer** already has obtained (from the **insurer entity** or from other transactions or events).
29. Notwithstanding the requirements in paragraph 28, a good or service in **an insurance contract** ~~a bundle of promised goods or services~~ is not distinct and, therefore, the **insurer entity** shall account for the **good or service together with the insurance component under the insurance contracts standard bundle as a single performance obligation, if both of the following criteria are met:**
- The good or service is ~~in the bundle~~ are highly interrelated **with the insurance component** and transferring them to the **policyholder customer** requires the **insurer entity** also to provide a significant service of integrating the good or service into the **combined insurance contract the insurer has entered into with the policyholder** ~~combined item(s) for which the customer has contracted.~~
  - The ~~bundle of~~ good or service is significantly modified or customized in order to fulfill the contract.
30. ~~As a practical expedient, an entity may account for two or more distinct goods or services as a single performance obligation if those goods or services have the same pattern of transfer to the customer. For example, if an entity promises to transfer two or more distinct services to a customer over the same period of time, the entity could account for these promises as one performance obligation if applying one method of measuring progress (as discussed in paragraphs 38–45) would faithfully depict the transfer of those services to the customer.~~

## Substantive Modifications Made to the Revenue Recognition Guidance

8. In this section of the paper, the staff will highlight any substantive differences between the proposed guidance for unbundling goods/services from an insurance

contract and the comparable guidance in the Exposure Draft *Revenue from Contracts with Customers*.

### ***Commonly Provided Goods and Services***

9. Paragraph 26 of the Exposure Draft *Revenue from Contracts with Customers* lists the goods or services that might be included in a sales contract. The first sentence of the paragraph points out to readers that the list is not intended to be all-inclusive.
10. The staff does not believe that a similar list would be useful in the insurance contracts project and it should therefore be omitted from the guidance about unbundling goods/services. There are a number of actions that are typically provided with insurance coverage that in some circumstances would be considered separate services but in other circumstances would be considered activities the insurer undertakes as part of fulfilling the contract.
11. For example, claims processing is often provided with health insurance coverage; however, other terms of the contract will determine whether the claims processing provides a service to the policyholder or whether it is merely an activity the insurer must undertake to fulfill its insurance obligation.
12. By explicitly stating the types of goods or services that might be subject to unbundling, this guidance might lead readers to believe that these types of goods or services should generally be separated (as a separate performance obligation) while application of the remaining guidance might result in a different conclusion. Therefore, the staff recommends omitting from the insurance contracts guidance a similar list to that which is included in paragraph 26 of the Exposure Draft *Revenue from Contracts with Customers*.

### ***Aggregation of Separately Provided Goods or Services***

13. The staff recommends omitting an equivalent to paragraph 27 of the Exposure Draft *Revenue from Contracts with Customers*. That paragraph pertains to potential aggregation of separately provided goods or services. One of the fundamental requirements of applying the guidance from the revenue recognition

project is to identify each of the separate performance obligations in a contract. In order to do so, an entity must aggregate goods and services that are not distinct until it is able to identify the separate performance obligation to which those goods or services belong.

14. Under the insurance contracts project, such goods or services will be captured regardless of whether they are distinct. The unbundling criteria are intended to identify those goods and services components that would be better accounted for under different guidance. If a good or service included in an insurance contract is not distinct, then its characteristics dictate that it should be accounted for as part of the broader contract and its expected cash flows considered in the measurement thereof. It is not essential, as it is under the revenue recognition project, that the goods/services be attributed to any particular performance obligation; they will be measured regardless as part of the measure of the insurance contracts liability.

### ***Pattern of Transfer***

15. Paragraph 30 of the Exposure Draft *Revenue from Contracts with Customers* reads:

As a practical expedient, an entity may account for two or more distinct goods or services as a single performance obligation if those goods or services have the same pattern of transfer to the customer. For example, if an entity promises to transfer two or more distinct services to a customer over the same period of time, the entity could account for those promises as one performance obligation if applying one method of measuring progress (as discussed in paragraphs 38–45) would faithfully depict the transfer of those services to the customer.

16. The core principle of the revenue recognition model is that revenue should be recognized in a manner to “depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services”. The ‘pattern of transfer’ practical expedient is derived from this core principle in that it indicates that an entity can combine performance obligations that should otherwise be separated so long as the core principle remains intact. Because the core principle is to recognize revenue to depict the transfer of control, the result of accounting for multiple performance obligations together or individually should be no different so long as they have the same ‘pattern of transfer’ to the customer.



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17. The same could not be said for goods/services components of an insurance contract. The implication of unbundling a good/service component from an insurance contract is that the component should be accounted for using different guidance than the remainder of the contract (although this effect would be more severe for a contract that is accounted for under the building blocks approach than under the premium allocation approach). Even if the ‘pattern of transfer’ of the promised good/service is identical to that of the insurance coverage, the results will differ because the components will be accounted for under differing guidance (as illustrated above in paragraph 6). The notion that two components will produce the same results when combined because they have identical patterns of transfer is invalid when such components would otherwise be measured and remeasured differently.
18. For example, assume that an automobile insurance contract were issued that provides a policyholder with the right to use a leased automobile in addition to the provided insurance coverage. In this example, the ‘pattern of transfer’ practical expedient would allow the insurer to keep the contract bundled (assuming that the benefit of both the insurance coverage and the leased automobile transfers evenly over the life of the contract) despite the fact that provision of the lease automobile is clearly a distinct performance obligation.
19. For the reasons stated above, the staff recommends omitting the ‘pattern of transfer’ practical expedient from the guidance for unbundling goods/services in the insurance contracts project.

### **Staff Recommendation**

20. The staff recommends that specified language be removed and/or revised from the criteria used for separating performance obligations in the revenue recognition project so that the guidance is applicable to insurance contracts. The staff has provided examples at appendix A to illustrate how the guidance would be applied.

**Question 1: Criteria for Unbundling Goods/Services**

Do the boards agree with the proposed criteria for unbundling goods/services components from insurance contracts as set out in paragraph 3? Those criteria do not contemplate potential unbundling of asset management services that are provided as part of account-driven contracts, which will be discussed at a future meeting.

## Appendix A- Illustration of the Proposed Guidance for Unbundling Goods/Services Components

**Purpose:** The purpose of this analysis is to illustrate how the proposed criteria would be applied to common contracts. Based on the criteria proposed in paragraph 3, an insurer would unbundle only if the good/service component is both of the following:

- 1- A performance obligation (as opposed to an activity of fulfilling the insurance coverage)
- 2- Distinct

Description / Facts	Analysis Using the Criteria for Identifying and Separating Performance Obligations from the Revenue Recognition Project
<p><b>Example 1</b>            A contract for a sale of a car with ‘free’ 3-year non-cancellable motor accident insurance. The insurer does not otherwise sell cars.             (This example has been previously brought up in board meetings by a board member.)</p>	<p><b>Is the component a good or service that transfers to the policyholder?</b> Yes, the car is a good that transfers to the policyholder.</p> <p><b>Is the good or service component distinct?</b> Yes, the car is distinct because the policyholder can use the car on its own. The car can be driven with motor insurance provided by another insurer.</p> <p><b>Result:</b> Unbundle the sale of the car and account for the sale of the car under revenue recognition requirements.</p>

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Description / Facts	Analysis Using the Criteria for Identifying and Separating Performance Obligations from the Revenue Recognition Project
<p><b>Example 1(a)</b></p> <p>Assume the same fact pattern as for example 1 except, in this example the vehicle was leased to the customer for a period of three years, as opposed to sold.</p> <p>(This example has been previously brought up in board meetings by a board member.)</p>	<p><b>Note:</b> The analysis for this example is identical to that provided in example 1.</p> <p><b>Result:</b> Unbundle the lease contract and account for the lease of the car under the leasing requirements.</p>
<p><b>Example 2</b></p> <p>An insurer may sell claims processing services on a stand-alone basis to a customer and might also sell those services bundled with a stop-loss insurance contract. To provide financial protection against catastrophic health insurance claims, some self-funding employers purchase stop-loss insurance from insurers. For the purpose of this example, assume the following fact patterns:</p>	
<p><b>2(a)</b> The customer has chosen to provide health insurance to its employee and has chosen to self-insure. Instead of processing the claims of the employees, the customer buys claims processing services from an insurer but does not purchase insurance coverage. The insurer will process the health insurance claims of the employees of the customer on behalf of the customer.</p>	<p>Not applicable. The claims processing services would not meet the definition of insurance. The insurer is providing claims-processing services and should account for those services under the revenue recognition requirements.</p>

Description / Facts	Analysis Using the Criteria for Identifying and Separating Performance Obligations from the Revenue Recognition Project
<p><b>2(b)</b>- Policyholder buys a stop-loss contract that provides:</p> <ul style="list-style-type: none"> <li>• 100% insurance coverage for aggregate group claims exceeding CU 25M. The policyholder will self-insure below this amount.</li> <li>• Claims processing services for the entirety of the upcoming 12 months, regardless of whether the policyholder has breached the stop-loss threshold of CU 25M. The insurer is responsible for processing the health insurance claims of the employees on behalf of the employer.</li> </ul> <p>The insurer sometimes sells claims-processing services as a standalone service absent any insurance coverage, as do a number of other entities.</p>	<p><b>Is the component a good or service that transfers to the policyholder?</b>  The policyholder is receiving:</p> <ol style="list-style-type: none"> <li>1) Stop-loss coverage to protect against aggregate claims exceeding CU 25M.</li> <li>2) Services to process the individual claims of its employees. Provision of these services to the policyholder represents transfer of a service for the entire 12-month period that enables the policyholder to fulfill its separate obligation to provide health insurance to its employees (as it self-insures).</li> </ol> <p><b>Is the good or service component distinct:</b> The claims-processing services are distinct in this example for either of the following reasons:</p> <ol style="list-style-type: none"> <li>1) The provided services benefit the policyholder independent of the insurance (ie absent the services, the policyholder would have to perform such services for its employees).</li> <li>2) The insurer sells such services on a standalone basis.</li> </ol> <p><b>Result:</b> Unbundle the claims-processing services for the duration of the contract.</p>

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<b>Description / Facts</b>	<b>Analysis Using the Criteria for Identifying and Separating Performance Obligations from the Revenue Recognition Project</b>
<p><b>Example 3</b> <b>High-deductible health insurance plan</b> Contracts are sold both to individuals and to groups, generally with an annual term. Under these contracts, the policyholder or group member is responsible for 100 percent of the costs at the beginning of the contract period up to a defined threshold or deductible amount. In this case, the deductible (sometimes referred to as an 'excess' amount) is CU 2,000. After the policyholder meets its deductible, the contract converts into a regular co-insurance arrangement whereby the insurer is responsible for 80 percent and the policyholder is responsible for 20 percent until the policyholder reaches an annual out-of-pocket maximum of CU 6,000, at which point the insurer is responsible for 100 percent. The insurer provides administrative services to the policyholder for the entire duration of the contract, which includes claims processing services and network access (the ability to obtain health services from specified health professionals, sometimes at a discount or at different deductible or co-insurance levels). The claims-processing services and network access are not sold separately by the insurer, nor could they be purchased from a third party.</p>	<p><b>Is the component a good or service that transfers to the policyholder?</b> In this example, no good or service transfers to the policyholder. The claims-processing and network access would be considered activities of the insurer because such services would be required of the insurer to fulfil its insurance obligation (ie claims processing allows the insurer to adequately assess a policyholder's benefit status without having to gather and audit data from the period prior to the policyholder having met their deductible or excess amount).</p> <p><b>Are the good or service components distinct?</b> Not applicable, because the claims-processing services and network access are activities of the insurer, as opposed to performance obligations.</p> <p><b>Result:</b> Do not unbundle either service at any point during the contract.</p>
<p><b>Example 4</b> <b>Health insurance contract with break in coverage (Similar to U.S. Medicare Part D)</b> An insurer contracts with an individual (the 'policyholder') to provide specified health benefits structured as follows: a) initial coverage with a limit, then b) a gap in coverage (the 'donut hole'), and then c)</p>	<p><b>Is the component a good or service that transfers to the policyholder?</b> The analysis in this example is similar to that in example 3. The claims-processing would be required for the</p>

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<b>Description / Facts</b>	<b>Analysis Using the Criteria for Identifying and Separating Performance Obligations from the Revenue Recognition Project</b>
<p>catastrophic coverage limits. In addition to the provision of insurance coverage, the contract stipulates that the insurer will provide claims-processing services regardless of the insured status (ie are they in the donut hole?) of the participants. The insurer does not sell the claims-processing services individually, nor does it sell this type of insurance coverage without the related administrative services.</p>	<p>insurer to fulfil its obligation under the insurance coverage, and therefore, such services would merely be activities of the insurer that need not be evaluated any further.</p> <p><b>Is the good or service component distinct:</b> Not applicable, because the claims-processing services are merely an activity of the insurer.</p> <p><b>Result:</b> Do not unbundle the claims-processing services.</p>