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STAFF PAPER

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Project	**Insurance contracts**
Paper topic	Unbundling: allocation of cash flows

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What is this paper about?

1. The boards have tentatively decided that some components of insurance contracts should be unbundled[1]. When the component is unbundled from the insurance contract, the insurer needs to allocate cash flows (inflows and outflows) related to the bundled product amongst the unbundled components. Respondents to the IASB Exposure Draft *Insurance contracts* (ED) and FASB Discussion Paper *Preliminary Views on the Insurance Contracts* (DP) raised questions about the complexity of this allocation and asked to clarify some proposals. This paper considers how to allocate cash flows to the unbundled components and gives clarification on proposals in the ED/DP.

2. Current tentative decisions on unbundling are presented in Appendix B.

[1] Unbundling refers to the separation of a non-insurance component from the insurance component prior to measurement, therefore the insurance component would be measured under the insurance contract standard and the other component would be measured according to an appropriate standard, for example the revenue recognition standard.

Staff recommendations

3. For components of the insurance contracts that the boards have tentatively decided to unbundle, the staff recommend the following (these recommendations form a package):

    (a) The cash flows allocated to an investment component and considered in the measurement (including interest credited) should be measured on stand-alone basis which means as if the insurer had issued the investment contract separately (without including the effect of any cross-subsidies or discounts/supplements). This is discussed in paragraph 10-15.

    (b) After excluding any cash flows allocated to unbundled investment components (or embedded derivatives recognised separately), the amount of consideration[2] and discounts/supplements should be allocated to the insurance component and/or goods and service component. The allocation should be done in accordance with proposals in paragraphs 70-80 of the exposure draft *Revenue from Contracts with Customers*. This is discussed in paragraphs 16-20.

    (c) Cash outflows related to more than one unbundled component (for example: acquisition and fulfilment costs) should be allocated to those components on a rational and consistent basis. Once allocated, the insurer would account for those costs in accordance with the recognition and measurement requirements that apply to that component. This is discussed in paragraphs 21-27.

4. The recommendations are presented in a diagram in Appendix A.

[2] The term ‘consideration’ in this paper means the cash inflows relating to taking on insurance risk and any goods or services provided. It would include fees deducted from the unbundled investment component.

Background information

ED/DP proposals

5. The ED/DP proposed that[3]:

   (a) specified (i) explicit account balances, (ii) embedded derivatives, and (iii) goods or services components should be unbundled and measured using the relevant requirements in IFRS/US GAAP.

   (b) some cash flows arising from the unbundled non-insurance components (eg net interest credited to the unbundled investment component) should not be included in estimating the cash flows of the insurance contract. The staff believe that the intention was that all cash flows related to the unbundled non-insurance components should be excluded from the estimation of cash flows for the insurance component.

   (c) an unbundled account balance should be treated as a financial instrument and would be credited with a rate that excludes the effect of any cross-subsidies. The intent of the ED/DP was that the cross-subsidies should be treated as belonging to the insurance component or to the other goods or services component (eg the asset management services), but not as part of the investment component. In other words, the investment component would be measured on a stand-alone basis.

6. The drafting of the ED/DP proposals on the allocation of the cross-subsidies was unclear and some misinterpreted the proposals as requiring an insurer to allocate the fees not related to the investment component either to the insurance component or to the goods or services component. This would result in allocating the whole consideration to one component, therefore the other component would be likely to result in a loss which would distort

[3] The boards tentatively decided to change some criteria for unbundling those components. Current decisions on unbundling could be found in Appendix B.

financial results. The staff believe that the boards' intention was simply to require that the cross-subsidies and discounts or supplements should not be allocated to the investment component, because they do not relate to that component.

7. The ED/DP did not specifically address how the contract's premium would be allocated when there is no investment component. The exposure draft *Revenue from Contracts with Customers* contained some guidance on how to separate an unbundled goods or services component if a different standard requires separation without specifying how the separation would be achieved.

Feedback received from comment letters, outreach activities and field tests

8. Some emphasised the difficulties in allocating fees and costs to the components. They argue that unbundling requires significant judgement and that allocating cash flows between the components might be difficult and possibly arbitrary. This increases the risk of inconsistent application of unbundling criteria and therefore reduces comparability between insurers.

9. Some contracts contain a relatively small insurance component when compared with the investment component present in the contract. For these contracts, allocation of expenses will be especially critical to make sure that the financial statements accurately depict the economics of the insurance component (eg for variable universal life[4]). Some constituents therefore commented on the importance of developing reliable allocation methodologies for these contracts.

[4] A universal life contract is offering the low cost protection of term life insurance as well as a savings element (like whole life insurance). Unlike whole life insurance, universal life insurance allows policyholders to shift money between the insurance and savings components of the policy.

Staff analysis

Allocation of cash flows to the investment component

10. The objective of unbundling is to account for an unbundled component in the same way as for stand-alone contracts with similar characteristics. Therefore, the unbundled investment component should be recognised and measured on stand-alone basis in accordance with financial instrument requirements.

11. The stand-alone contract would not reflect any cross-subsidies or discounts/supplements arising from the presence of other components. For example, suppose an investment component if sold separately is credited with 5% interest. Furthermore, suppose that in a bundled contract (with insurance component) the interest credited to account balance would equal 3% (5% less cross-subsidy of 2%). Measuring the unbundled investment component on a stand-alone basis would result in assuming interest credited of 5% and would treat the implicit cross-subsidy of 2% as a cash inflow relating to the insurance component.

12. Moreover, applying the Financial Instrument standard, the insurer would use a fair value measurement at initial recognition. If the cash flows attributed to that component differ from cash flows that would arise from an equivalent stand-alone contract, a gain or loss would arise.

13. As discussed in paragraph 5(c), the staff believe that the stand-alone basis is consistent with the intention of the proposals in the ED/DP. The cross-subsidies together with fees deducted from the investment component (which are not related to the investment component) should be allocated as part of the consideration to the insurance or goods and services component. This is discussed in paragraphs 16-20. The transaction costs should be allocated to the investment and other components based on criteria for allocating cash outflows such as fulfilment costs and acquisition costs as described in paragraphs 21-27.

14. The staff also noted that according to the boards' tentative decision at the May 2012 meeting, one of the indicators for unbundling a distinct investment component is that both components (investment and insurance component) are sold in the same market or jurisdiction. This would imply that two distinct components exist and therefore insurer would be able to reliably measure both components on a stand-alone basis.

15. Based on the arguments in previous paragraphs the staff recommends that the boards should confirm the ED/DP proposals that the cash flows allocated to an investment component and considered in the measurement (including interest credited) should be measured on a stand-alone basis which means as if the insurer had issued the investment contract separately (without including the effect of any cross-subsidies or discounts/supplements).

Question 1—allocation of cash flows to the investment component
Do the boards agree with staff recommendation that the cash flows allocated to an investment component and considered in the measurement (including interest credited) should be measured on stand-alone basis which means as if the insurer had issued the investment contract separately (without including the effect of any cross-subsidies or discounts/supplements)?

Consideration for the bundled contract

16. As noted in paragraph 13 the premium received (or receivable from policyholder) and/or fees deducted from the unbundled investment component forms the consideration to be allocated to insurance or goods and services components (as typically those relate to those components).

17. Sometimes the insurer may charge more (a supplement) or less (a discount) for the bundled contract than the sum of the prices for each component. For example, suppose that in the bundled contract the premium for the insurance component equals CU100 and the fees deducted for investment management equal CU200. If the amount charged for the bundled contract were CU250,

there is a discount of CU50 (CU300-CU350) to the insurance or goods and services components.

18. The staff note that unbundling criteria for goods and services and investment component are based on the Revenue ED criteria for unbundling separate performance obligations. Therefore the staff believe that in order to allocate the consideration and discounts/supplements to the insurance and goods and services component, an insurer should use the proposals from the ED *Revenue from Contracts with Customers* (Revenue ED) related to allocation of transaction price to separate performance obligations (paragraphs 70-80 of the Revenue ED). The analysis of why those paragraphs are applicable to insurance is included in the table below.

Relevant proposal in the Revenue ED	Staff analysis
70. For a contract that has more than one separate performance obligation[5], an entity shall allocate the transaction price to each separate performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate performance obligation. 71. To allocate an appropriate amount of consideration to each separate performance obligation, an entity shall determine the stand-alone selling price[6] at contract inception of the good or service underlying each separate performance obligation and allocate the	The staff believes that this applies equally to insurance contracts where goods or services meet the criteria to be unbundled from the insurance component. That is, the performance obligation is distinct if the insurer regularly sells the good or services separately or 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. Therefore, in most situations, the insurer will be able to determine an observable stand-alone selling price for the goods or services and the insurance component.

[5] This is defined in the Revenue ED as 'a promise in a contract with a customer to transfer a good or service to the customer'.

[6] This is defined in the Revenue ED as 'the price at which an entity would sell a promised good or service separately to a customer'.

Relevant proposal in the Revenue ED	Staff analysis
transaction price on a relative stand-alone selling price basis. 72. The best evidence of a stand-alone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. A contractually stated price or a list price for a good or service may be (but shall not be presumed to be) the stand-alone selling price of that good or service.	
73. If a stand-alone selling price is not directly observable, an entity shall estimate it. When estimating a stand-alone selling price, an entity shall consider all information (including market conditions, entity-specific factors and information about the customer or class of customer) that is reasonably available to the entity. In addition, an	If the stand-alone selling price is not directly observable because the insurer does not sell the (i) insurance and (ii) goods or services components separately or if the consideration charged for the two components differs from the stand-alone selling prices, an insurer would need to estimate the consideration to be allocated to each component. The staff believe the techniques described in the

Relevant proposal in the Revenue ED	Staff analysis
entity shall maximise the use of observable inputs and shall apply estimation methods consistently in similar circumstances. Suitable estimation methods include, but are not limited to, the following:	Revenue ED would be applicable to contracts that combine an insurance component and goods or services components. This is described in more detail below.
(a) Adjusted market assessment approach—an entity could evaluate the market in which it sells goods or services and estimate the price that customers in that market would be willing to pay for those goods or services. That approach might also include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.	Because the tentative decision by the boards requires unbundling when 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, if there isn't an entity specific price then there would be a market price and thus an adjusted market assessment approach would be appropriate and operationally plausible.
(b) Expected cost plus a margin approach—an entity could forecast its expected costs of satisfying a performance obligation and then add	In the measurement of the insurance contract liability, the insurer is identifying all the expected cash outflows at the coverage effective date for the entire contract. Separating

Relevant proposal in the Revenue ED	Staff analysis
an appropriate margin for that good or service.	these costs between the fulfilment of the insurance contract (at least the benefit/claim piece and the costs to fulfill that obligation) and the costs for the service or good component will typically be obvious. The insurer would also presumably know the profit margin for the components the insurer is selling and how the typical profit margin is adjusted. Therefore, the staff believe this method is also operationally plausible.
(c) Residual approach—if the stand-alone selling price of a good or service is highly variable or uncertain, then an entity may estimate the stand-alone selling price by reference to the total transaction price less the sum of the observable stand-alone selling prices of other goods or services promised in the contract. A selling price is highly variable when an entity sells the same good or service to different customers (at	In the unlikely scenario that the standalone selling price of the insurance component and the good or service is highly variable or uncertain the insurer may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of either the insurance component or the goods and services components promised in the contract not just to the goods and services component.

Relevant proposal in the Revenue ED	Staff analysis
or near the same time) for a broad range of amounts. A selling price is uncertain when an entity has not yet established a price for a good or service and the good or service has not previously been sold.	
74. If the sum of the stand-alone selling prices of the promised goods or services in the contract exceeds the transaction price (ie if a customer receives a discount for purchasing a bundle of goods or services), an entity shall allocate that discount to all separate performance obligations on a relative stand-alone selling price basis except as specified in paragraphs 75 and 76. 75. An entity shall allocate a discount entirely to one (or some) separate performance obligation(s) in the contract if both of the following criteria are met:	Discounts and cross-subsidies would be allocated based on observable evidence to one or both components.

Relevant proposal in the Revenue ED	Staff analysis
(a) the entity regularly sells each good or service (or each bundle of goods or services) in the contract on a stand-alone basis; and (b) the observable selling prices from those stand-alone sales provide evidence of the performance obligation(s) to which the entire discount in the contract belongs.	
76. If the transaction price includes an amount of consideration that is contingent on a future event or circumstance (for example, an entity's performance or a specific outcome of the entity's performance), the entity shall allocate that contingent amount (and subsequent changes to the amount) entirely to a distinct good or service if both of the following criteria are met: (a) the contingent payment terms for the	Any contingent consideration would be allocated to the appropriate component (insurance or goods and services).

Relevant proposal in the Revenue ED	Staff analysis
distinct good or service relate specifically to the entity's efforts to transfer that good or service (or to a specific outcome from transferring that good or service); and (b) allocating the contingent amount of consideration entirely to the distinct good or service is consistent with the allocation principle in paragraph 70 when considering all of the performance obligations and payment terms in the contract.	

Relevant proposal in the Revenue ED	Staff analysis
Changes in the transaction price 77. After contract inception, the transaction price can change for various reasons, including the resolution of uncertain events or other changes in circumstances that change the amount of consideration to which the entity expects to be entitled in exchange for the promised goods or services. 78. An entity shall allocate to the separate performance obligations in the contract any subsequent changes in the transaction price on the same basis as at contract inception. Amounts allocated to a satisfied performance obligation shall be recognised as revenue, or as a reduction of revenue, in the period in which the transaction price changes.	The staff believe that any subsequent changes in the bundled transaction price should be allocated to either the insurance or goods and services components on the same basis as at contract inception and recognise according to the applicable model (i.e., insurance or revenue recognition). However, any changes in the standalone selling prices after contract inception should not impact the allocation, consistently with the Revenue ED. The staff note that at the April 2012 joint meeting, the boards tentatively decided if the change in transaction price results in: a. additional benefits to the policyholder, the insurer should treat the modification as if the amendment was a new standalone contract b. eliminating benefits from the policyholder, the

Relevant proposal in the Revenue ED	Staff analysis
79. An entity shall allocate a change in the transaction price entirely to one or more distinct goods or services only if the criteria in paragraph 76 are met. 80. An entity shall not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception.	insurer should derecognize that portion of its obligation

19. In the above, the staff considered differences and potential operational issues which might result from applying those proposals and did not find any significant issues.

20. The staff note that the approach used in the Revenue ED uses inputs such as transaction price or stand-alone selling price that are determined consistently with revenue model. Therefore in applying proposals from Revenue ED to insurance contracts, the inputs need to be consistent with the insurance model. Staff would consider those differences in drafting.

Question 2—allocating the consideration to the unbundled insurance and goods or services components
Do the boards agree that after excluding any cash flows allocated to unbundled investment components (or embedded derivatives recognised separately); the amount of consideration and discounts/supplements should be allocated to the insurance component and/or goods and service component in accordance with proposals in paragraphs 70-80 of the exposure draft *Revenue from Contracts with Customers?*

Cash outflows: acquisition costs and fulfilment costs

21. When some components are unbundled, a difficulty arises because unbundling requires allocating some outflows, such as: fulfilment costs and other expenses such as acquisition costs. Sometimes those costs do not clearly relate to one of the components but arise from acquiring and fulfilling the contract as whole.

22. The ED/DP contains guidance for allocating the acquisition costs and fulfilment costs that cover more than one portfolio to the individual portfolios (eg salaries of a claims handling department working on more than one portfolio). The guidance (paragraph B63) requires an insurer to allocate those costs on a rational and consistent basis. This guidance was based on the IAS11 *Construction contracts*. The staff also note that this guidance is consistent with other IFRSs such IAS2 *Inventories* for allocating costs of production to

products. Under US GAAP, ASC Topic 605-35-25 relating to contract costs for construction-type contracts requires the methods of allocating indirect costs to be "systematic and rational" and recognizes that the methods of allocation depend on the circumstances and involved judgment. ASC Topic 330-10-30 relating to inventory requires costs to be allocated based on actual use or normal capacity of production facilities. The staff believe that the same principle should be applied when allocating costs between unbundled components.

23. The staff therefore recommend making it clear that the principle of using a 'rational and consistent' basis which the staff believe is the equivalent of systematic and rational applies not only in allocating costs to portfolios of insurance contracts as a whole, but also in allocating costs to unbundled components of insurance contracts. This approach would permit an insurer to allocate costs in a way that is appropriate.

24. Once costs have been allocated, they should be accounted for in accordance with the requirements applicable to the components to which they have been allocated. Thus, costs allocated to the insurance component would be treated consistently with those for other insurance contracts. Costs allocated to other components would be accounted for in accordance with the requirements applicable to those other components

25. While the accounting for acquisition and fulfilment costs may differ based on the guidance being applied to the specific component (which the staff believes is appropriate based on the characteristics of the components based on analyses in prior agenda papers), the principle of allocating these costs using a 'rational and consistent' basis will take into consideration the different characteristics of the components and the pricing thereof. Also, because of the difficulty in allocating some of these costs in a non-arbitrary way, we think specifying a single method of allocation is overly prescriptive

Why is the recommendation for the costs allocation different from the recommendation for the consideration allocation?

26. The staff do not recommend that the acquisition costs and fulfilment costs of the contract should be allocated using exactly the same criteria as for allocating the contract's consideration. The staff believe that even though the principle would work, it might be confusing how to apply some details. For example 'expected costs plus margin technique' may not be applicable for allocating costs. On the other hand, allocating those costs on a 'rational and consistent' basis as recommended in paragraphs 21-24 would permit the insurer to allocate the costs in a manner that is appropriate and consistent with other accounting standards.

27. We have considered also whether to allow the insurer to allocate the consideration on a 'rational and consistent' basis, consistently with our recommendation for the allocation of the specified acquisition and fulfilment costs. However, we were concerned that most insurers would apply the least costly basis to allocate the cross-subsidies and discounts/supplements—for example, to allocate those to only one of the components or would allocate to obtain the financial results that would be most beneficial at the time. We believe that the stand-alone relative consideration appropriately allocates those cross-subsidies and discounts/supplements and that, the insurer should therefore be required to apply that technique.

Question 3—allocation of the specified acquisition and fulfilment costs to the unbundled components
Do the boards agree that: (a) cash outflows related to more than one component (for example: acquisition and fulfillment costs) should be allocated to those components on a rational and consistent basis? (b) once allocated, the insurer would account for those costs in accordance with the recognition and measurement requirements that apply to that component?

Appendix A: A flowchart illustrating tentative decisions for unbundled components and the recommendations in this paper

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- accounted for as a financial instrument
- treated on a stand-alone basis with no allocation of discounts (Question 1)
- some fees deducted from the investment component and cross-subsidies and discounts/supplement allocated as part of the consideration to the insurance or/and goods and services component (Question2)

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- Consideration (premiums and fees) and discounts/supplements shall be allocated to the (i) insurance and (ii) goods or services components (Question 2)
- Acquisition and fufillment costs related to more than one component shall be allocated on a rational and consistent basis (Question 2)
- Accounted for using the revenue standard

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- Consideration (premiums and fees) and discounts/supplement must be allocated to the (i) insurance and (ii) goods or services components (Question 2)
- Acquistion and fufillment costs related to more than one component shall be allocated on a rational and consistent basis (Question 3)
- Accounted for in accordance with the insurance contracts standard

Appendix B: Current tentative decisions of the Boards on unbundling

B1. At their meeting in the week commencing 21 March 2011, the boards tentatively confirmed the proposal in the ED/DP that an insurer should account separately for embedded derivatives contained in a host insurance contract that is not closely (and clearly for FASB) related to the embedded derivative.

B2. At their meeting in the week commencing 27 February 2012, the boards tentatively decided on the following criteria for unbundling goods and services:

(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 US 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 by 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 the following paragraph, 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 has already obtained (from the insurer or from other transactions or events).

(d) Notwithstanding the requirements in the previous paragraph, a good or service in an insurance contract is not distinct and the insurer shall therefore 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 that the insurer has entered into with the policyholder.

(ii) The good or service is significantly modified or customised in order to fulfil the contract.

B3. At their May 2012 meeting the boards decided that: if the investment component is distinct, an insurer shall unbundle the investment component and apply the applicable IFRSs or US GAAP in accounting for the investment component.

(a) An investment component is distinct if the investment component and the insurance component are not highly interrelated.

(b) Indicators that an investment component is highly interrelated with an insurance component are:

(i) a lack of possibility for one of the components to lapse or mature without the other component also lapsing or maturing,

(ii) if the products are not sold in the same market or jurisdiction, or

(iii) if the value of the insurance component depends on the value of the investment component or if the value of the investment component depends on the value of the insurance component.

(c) An insurer shall account for investment components that are not distinct from the insurance contract together with the insurance component under the insurance contracts standard.

B4. At their meeting in the week commencing 19 March 2012, the IASB and FASB tentatively decided that:

(a) an investment component in an insurance contract is an amount that the insurer is obligated to pay the policyholder or a beneficiary regardless of whether an insured event occurs.

(b) In the statement of financial position, insurers should not be required to present investment components separately from the insurance contract. However insurer should disclose both:

(i) the portion of the insurance contract liability that represents the aggregated portions of premiums received (and claims / benefits paid) that were excluded from the statement of comprehensive income; and

(ii) the amounts payable on demand.

B5. In addition, the IASB tentatively decided that insurers should exclude from the aggregate premium presented in the statement of comprehensive income the present value of the amounts the insurer is obligated to pay to policyholders or their beneficiaries regardless of whether an insured event occurs, determined consistently with measurement of the overall insurance contract liability. [The FASB did not vote on this issue.]