IFRS

STAFF PAPER

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Project	**Insurance Contracts**		
Paper topic	Business combinations		
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Purpose and structure of the paper

1. This paper discusses the following topics:

    (a) business combinations: classification of acquired contracts as insurance contracts; and

    (b) business combinations: identification of insured event for acquired insurance contracts.

2. For each topic, this paper provides:

    (a) an overview of the requirements in IFRS 17 *Insurance Contracts*;

    (b) a summary of the International Accounting Standards Board's (Board) rationale for setting those requirements, including an overview of the Board's previous discussions;

    (c) an overview of the concerns and implementation challenges expressed since IFRS 17 was issued; and

    (d) the staff analysis, recommendation and a question for Board members.

Summary of staff recommendations

3. The staff recommend that the Board should not amend the requirements in IFRS 17 or IFRS 3 *Business Combinations* for the following topics:

   (a) business combinations: classification of acquired contracts as insurance contracts; and

   (b) business combinations: identification of insured event for acquired insurance contracts.

Business combinations: classification of acquired contracts as insurance contracts

IFRS 17 requirements

4. IFRS 17 amended IFRS 3 so that the assessment of whether contracts acquired in a business combination are insurance contracts is made on the basis of terms and conditions at the acquisition date, rather than at the inception of the contract as previously required by IFRS 3. In June 2018, the Board tentatively decided to amend IFRS 3 so that the amendment introduced by IFRS 17 applies only to business combinations that occur when or after IFRS 17 is effective.[1]

Board's rationale

5. IFRS 17 amended IFRS 3 by removing an exception to the general classification requirements in IFRS 3 that was introduced for insurance contracts accounted for applying IFRS 4 *Insurance Contracts*—an interim Standard. That exception required an entity to classify contracts as insurance contracts on the basis of the contractual terms and other factors at the inception of the contract, rather than at the date of acquisition. By removing that exception, IFRS 17 introduces consistent accounting for

[1] See Agenda Paper 2A for the June 2018 Board meeting.

insurance contracts and other contracts acquired in a business combination. The removal of that exception thus aligns the accounting for insurance contracts with the usual approach to business combination accounting.

6. As noted in paragraph BC187 of the Basis for Conclusions on IFRS 3, the Board decided that providing a general principle for classifying contracts acquired in a business combination would facilitate consistent application of IFRS 3. It observed that application of the acquisition method results in the initial recognition in the acquirer’s financial statements of the assets acquired and liabilities assumed in a business combination. Therefore, in principle, the acquirer should classify and designate all items acquired in a business combination at the acquisition date in the context of the contractual terms, economic conditions and other pertinent factors at that date. That classification principle for business combination accounting is one of the foundations of IFRS 3.

7. In redeliberating the proposals in the 2013 Exposure Draft *Insurance Contracts*, the Board:[2]

   (a) considered the concerns about a lack of clarity about the requirements for insurance contracts acquired in a business combination discussed in paragraph 18 of this paper; and

   (b) decided to clarify that such contracts should be accounted for as if they had been issued by the entity (the acquirer) at the date of the business combination.

Concerns and implementation challenges expressed since IFRS 17 was issued

8. Some stakeholders are concerned that the requirement to assess the classification of contracts acquired on the basis of terms and conditions at the acquisition date instead of on the date of the contract inception adds complexity and costs and could result in different accounting for the same contract in different reporting levels in a group of

[2] See Agenda Paper 2D for the May 2014 Board meeting.

entities. For example, a five-year contract with an investment component providing insurance coverage for the first two years:

(a) might meet the definition of an insurance contract at its inception date (and so would be accounted for as an insurance contract throughout its life by an acquiree); and

(b) might not meet the definition of an insurance contract at an acquisition date occurring after the end of Year 2 (and so would not be accounted for as an insurance contract by an acquirer).

9. Some stakeholders suggest re-introducing an exception to the general classification requirements in IFRS 3 for insurance contracts and making the use of that exception optional for an entity. Other stakeholders do not support re-introducing an exception and note that the classification of insurance contracts based on terms and conditions at the acquisition date avoids operational complexity.

Staff analysis and recommendation

10. As discussed in paragraphs 5−7 of this paper, the Board decided on the requirements about insurance contracts acquired in a business combination considering the feedback during the development of IFRS 17.

11. The staff think that an amendment to IFRS 3 to re-introduce an exception for insurance contracts to the general classification requirements in IFRS 3 would not unduly disrupt implementation processes that are already under way because the consequential amendment to IFRS 3 applies only to business combinations that occur when or after IFRS 17 is effective.

12. However, the staff think that such an amendment would cause significant loss of useful information relative to that which would be provided by IFRS 3 as amended by IFRS 17, by increasing the complexity for users of financial statements because it will reduce comparability with the requirements for other transactions.

13. At the November 2016 Board meeting, the Board explicitly considered another difference in accounting for insurance contracts between an acquiree and an acquirer: an entity will need to calculate different contractual service margins for the consolidated financial statements and the separate financial statements of the subsidiary that issued the contract. This is because an entity is required to use the fair value at the date of the business combination to determine the contractual service margin for contracts in the consolidated financial statements. The Board noted that this difference reflects that the reporting entity in consolidated financial statements acquired the contracts on a different date from the inception of the contracts for the subsidiary. Hence, the Board confirmed that such differences were a normal consequence of acquisition accounting applying IFRS Standards.

14. Differences in accounting caused by a business combination are not unique to insurance contracts and are not unusual when applying IFRS Standards. Other IFRS Standards do not require exceptions to the classification principles in IFRS 3.[3] For example, a financial asset classified as measured at amortised cost by an acquiree will be assessed by an acquirer at the date of acquisition and may not be eligible for classification in that category in the acquirer's financial statements even if it is eligible in the financial statements of the acquiree. As discussed in the *Effects Analysis on IFRS 17*, applying commonly understood IFRS principles to many aspects of the accounting for insurance contracts is expected to make the insurance sector more attractive to investors, facilitating comparability between insurers and entities in other industries and improving capital allocation.

15. Accordingly, the staff think that amending the requirements in IFRS 17 and IFRS 3 relating to the classification of contracts acquired in a business combination as insurance contracts would result in a loss of comparability with the requirements for other transactions and therefore would cause a significant loss of useful information. Therefore, the staff recommend that the Board should not amend IFRS 17 or IFRS 3

[3] The only exception in IFRS 3 for the classification of acquired assets and liabilities is for the classification of lease contracts in which the acquire is a lessor. That exception was retained when IFRS 16 was issued because IFRS 16 did not change accounting by lessors.

relating to the classification of contracts acquired in a business combination as insurance contracts.

Question 1 for Board members
Do you agree that the Board should not amend the requirements in IFRS 17 or IFRS 3 relating to the classification of contracts acquired in a business combination as insurance contracts?

Business combinations: identification of insured event for acquired insurance contracts

IFRS 17 requirements

16. Paragraph B93 of IFRS 17 requires an entity to identify groups of insurance contracts as if it had entered into the contracts on the acquisition date. Paragraph B5 of IFRS 17 states that for insurance contracts that cover events that have already occurred, the insured event is the determination of the ultimate cost of those claims. Hence an entity treats insurance contracts acquired in a business combination that cover events that have already happened as providing coverage for the adverse development of claims. This means that the entity recognises a liability for remaining coverage and recognises revenue for the insurance service provided and expenses for the claims incurred.

Board's rationale

17. As noted in paragraph 5 of this paper, the requirements in IFRS 17 for insurance contracts acquired in a business combination apply the general principles of business combinations in IFRS 3 to insurance contracts.

18. In redeliberating the proposals in the 2013 Exposure Draft, the Board:[4]

    (a) considered that a few respondents to the 2013 Exposure Draft sought clarification on how they should account for contracts acquired in a business

[4] See Agenda Paper 2D for the May 2014 Board meeting.

combination when their coverage period has ended and the contracts are in the settlement period. Those respondents stated that the requirements in the 2013 Exposure Draft were unclear as to whether an insurance contract in its settlement period should be treated as:

(i) the remainder of a pre-existing contract that is in its post-coverage period; or

(ii) a new insurance contract that is at the beginning of its coverage period.

(b) decided to clarify that contracts acquired in a business combination should be recognised from the date of the business combination as new contracts (ie they should be accounted for as if they had been issued by the entity at the date of the business combination). When an entity acquires a contract in its settlement period in a business combination, the entity has written a new contract in which the insured event is the discovery of a loss or the adverse development of claims for past events. The insured event is not the event giving rise to the claims in the first place.

Concerns and implementation challenges expressed since IFRS 17 was issued

19. Consistent with the feedback during the development of IFRS 17, some stakeholders noted that applying IFRS 17 requirements to contracts acquired in a business combination reflects a significant change from existing practice and results in implementation challenges and costs.

20. For example, consider an entity that issues insurance contracts that have an insurance coverage period of one year and acquires similar contracts in their settlement period in a business combination. The settlement period for both sets of contracts is expected to be many years and there is substantial uncertainty over the ultimate amount that will be paid in claims. In such cases, entities would need to apply the general model to the acquired contracts, although they could choose to apply the premium allocation approach (PAA) for the contracts they issue. Hence some stakeholders state that entities may need to make systems changes to determine contractual service margins

in preparation for potential future acquitions, even if all their existing contracts are eligible for the PAA and hence do not require determination of a contractual service margin.

21. In addition, some of those stakeholders expressed the view that users of financial statements could consider the information provided applying IFRS 17 requirements to be misleading or counterintuitive because similar contracts will be accounted for differently based on whether they have been issued by an entity or acquired by the entity during their settlement period—contracts acquired in their settlement period will be considered part of the liability for remaining coverage for the entity that acquired the contract and not part of the liability for incurred claims. Some stakeholders also expressed the view that the requirements of IFRS 17 result in revenue and expenses for the same contract being recognised twice, once by the acquiree in the original coverage period and subsequently by the acquirer in the period of coverage for adverse development of claims.

22. Some stakeholders observed that different treatments might be appropriate for different circumstances:

    (a) for entities with a business model to acquire and run-off the settlement of claims, it might be more appropriate to treat the acquired liability as a liability for remaining coverage, giving rise to revenue and expenses; and

    (b) for entities purchasing contracts in the expectation of getting future renewals of those contracts, it might be more appropriate to treat the acquired liability as a liability for incurred claims, thereby not creating revenue or expenses for claims incurred previously recognised by the acquiree.

23. These stakeholders think this issue is similar to an implementation question discussed at the September 2018 Transition Resource Group for IFRS 17 (TRG) meeting not related to business combinations—whether the entity’s obligation to pay amounts subject to insurance risk after an incurred claim should be treated as:

    (a) a liability for incurred claims; or

    (b) a liability for remaining coverage.

24. On this question, TRG members observed that the definitions of IFRS 17 allow an entity to use judgement when determining whether the obligation to pay amounts subject to insurance risk after an incurred claim is part of a liability for remaining coverage or a liability for incurred claims. Stakeholders argue that an acquirer of an insurance contract for which the claim has occurred should be allowed to exercise the same judgement.

Staff analysis and recommendation

25. As discussed in paragraph 18 of this paper, the Board decided on the requirements for insurance contracts acquired in a business combination considering the feedback during the development of IFRS 17.

26. As with the first topic discussed in this paper, application of the acquisition method results in the initial recognition in the acquirer's financial statements of the assets acquired and liabilities assumed in a business combination. The acquirer identifies the assets and liabilities acquired based on the contractual terms and economic conditions that exist at the acquisition date and applies the requirements of IFRS 17 accordingly. From the perspective of the acquirer, applying paragraph B5 of IFRS 17 (see paragraph 16 of this paper) it has received the fair value of the contract in return for providing coverage for adverse development of a claim. That is the case whatever the reason for the acquirer making the acquisition. Further, the acquirer of the contract is in a different position to the issuer of the contract in respect of the judgement discussed in paragraph 24 of this paper. From the perspective of the acquirer, the coverage for adverse development of a claim is *the only* insurance coverage provided under the contract. Given the contract is to be treated as an insurance contract, it must be regarded as providing insurance service for that coverage.

27. As noted in paragraph 14 of this paper, there are other assets and liabilities that are accounted for differently by the entity that holds the assets and liabilities and the acquiring entity after a business combination. In such cases, additional disclosures might be necessary to provide information that enables users of financial statements to

evaluate the nature and financial effect of a business combination according to paragraph 59 of IFRS 3. These disclosures, together with those required by IFRS 17, may mitigate some of the concerns raised above.

28. The staff note that all entities applying the general model will need to develop mechanisms to determine the contractual service margin. Therefore, additional implementation costs arise only for entities that expect all contracts they issue will be eligible for the PAA, other than those they acquired in a business combination.

29. The staff think that an amendment to introduce an exception to the general requirements for the determination of the insured event for insurance contracts acquired in a business combination as suggested by some stakeholders would cause significant loss of useful information relative to that which would be provided by IFRS 17. It would increase the complexity for users of financial statements because it would reduce comparability with the requirements for other transactions.

30. The staff therefore recommend that the Board should not amend the requirements in IFRS 17 relating to the determination of the insured event for insurance contracts acquired in a business combination.

Question 2 for Board members
Do you agree that the Board should not amend the requirements in IFRS 17 relating to the determination of the insured event for insurance contracts acquired in a business combination?