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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**19 April 2007, London**
Project:	**Business Combinations II**
Subject:	**Insurance Contracts – Cover Memo (Agenda Paper 2F)**

INTRODUCTION

1. Paragraphs 31-33 of IFRS 4 contain the following requirements on the accounting for insurance contracts acquired in a business combination:

> 31. To comply with IFRS 3, an insurer shall, at the acquisition date, measure at fair value the insurance liabilities assumed and the insurance assets acquired in a business combination. However, an insurer is permitted, but not required, to use an expanded presentation that splits the fair value of acquired insurance contracts into two components:
>
> (a) a liability measured in accordance with the insurer's accounting policies for insurance contracts that it issues; and
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> (b) an intangible asset, representing the difference between (i) the fair value of the contractual insurance rights acquired and insurance obligations assumed and (ii) the amount described in (a). The subsequent measurement of this asset shall be consistent with the measurement of the related insurance liability.

> 32. An insurer acquiring a portfolio of insurance contracts may use the expanded presentation described in paragraph 31.
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> 33. The intangible assets described in paragraphs 31 and 32 are excluded from the scope of IAS 36 *Impairment of Assets* and IAS 38. However, IAS 36 and IAS 38 apply to customer lists and customer relationships reflecting the expectation of future contracts that are not part of the contractual insurance rights and contractual insurance obligations that existed at the date of a business combination or portfolio transfer.

2. The IASB ED does not propose additional requirements for insurance contracts acquired in a business combination. In contrast, the FASB ED proposes:

   a. in paragraph 35 that contingent assets and liabilities, including insurance contracts, should initially be measured at fair value; and

   b. in paragraph 36 that after initial recognition a contingency that is an asset or liability arising from an insurance contract should be accounted for in accordance with US GAAP requirements on insurance contracts (including the intangible asset, if any, recognised for the difference between the amount recognised on the acquisition date at fair value and the amounts that would be recognised in accordance with Statement No. 60, *Accounting and Reporting by Insurance Enterprises*).

3. The FASB discussed the accounting for insurance contracts acquired in a business combination on 13 February 2007 and will deliberate some follow-up questions on 18 April, 2007. The FASB Memoranda are provided as Agenda Papers 2G and 2H at this Board meeting. *[The FASB Memoranda provided to the Board as Agenda Papers 2G and 2H are not published as observer notes. Instead, the FASB Education Session Handouts summarising the FASB Memoranda have been provided as Observer Notes 2G and 2H.]* The purpose of this agenda paper is to give an overview of the issues deliberated by the FASB and to ask the IASB whether it wishes to discuss some of the issues identified by the FASB.

4. The staff has regrouped the issues discussed in the FASB memoranda into the following categories:

   a. Issues that could be relevant under IFRSs;

b. Issues that could be relevant under IFRSs, but for which IFRS 4 does not provide detailed requirements;

c. Issues that are addressed by more general principles; and

d. Issues that are not relevant under IFRSs.

5. In addition to those issues, the staff has identified one question that applies to the IASB only.

IASB ONLY ISSUE

Issue 1 – Should the expanded presentation in paragraph 31 of IFRS 4 be optional or mandatory?

6. The fair value measurement principle requires measuring all assets acquired and liabilities assumed in a business combination at their acquisition date fair value. Paragraph 31 of IFRS 4 confirms that this principle continues to apply to insurance assets acquired, and insurance liabilities assumed, in a business combination.

7. In practice, insurers have often used an expanded presentation to account for insurance contracts acquired in a business combination. Paragraph 31 of IFRS 4 explicitly permits, but does not require, such an expanded presentation (see paragraph 1 of this paper). In contrast, the FASB ED would require the expanded presentation.

8. The main purpose of the expanded presentation in IFRS 4 was to maintain the long-standing requirement to measure at fair value the identifiable assets and liabilities acquired, while permitting insurers to use existing measurement approaches for the insurance liabilities so that insurers need not make systems changes that become obsolete in phase II of the IASB's project on insurance contracts. Paragraph BC148 of IFRS 4 explains further:

> For the following reasons, the Board decided to permit these existing practices during phase I […]:

(a) One objective of phase I is to avoid prejudging most phase II issues and to avoid requiring systems changes for phase I that might need to be reversed for phase II. In the meantime, disclosure about the nature of and changes in, the related intangible asset provides transparency for users.

(b) The IFRS gives no guidance on how to determine the fair value of insurance liabilities, because that would be premature in phase I. Thus fair values identified during phase I might need to be changed in phase II.

(c) It may be difficult to integrate a fair value measurement at the date of a business combination into subsequent insurance contract accounting without requiring systems changes that could become obsolete in phase II.

9. The staff has considered whether the IASB should converge with the FASB requirements and require, rather than merely permit, an expanded presentation of the fair value of insurance contracts acquired in a business combination.

10. The IASB ED did not propose eliminating the option for an acquirer to present insurance liabilities acquired in a business combination at fair value. We note further that respondents to the IASB ED did not suggest removing the option. Hence, the staff believes that there is no reason to revisit the requirements of paragraph 31 of IFRS 4 in phase II of the business combinations project.

11. The IASB discussed the expanded presentation in May 2006 in phase II of its project on insurance contracts. The IASB noted that, if any significant differences remain between current exit value and fair value when the IASB completes phase II of this project, it may be necessary to consider retaining the expanded presentation. If no significant differences remain, the expanded presentation will become redundant.

12. ***Does the Board agree that the expanded presentation described in paragraph 31 of IFRS 4 should continue to be optional, not mandatory?***

ISSUES THAT COULD BE RELEVANT UNDER IFRSs

Issue 2 – Pre-acquisition Contract Balances

13. A question arises as to whether any pre-acquisition contract balances should be carried forward to the post-acquisition financial statements in applying the expanded presentation. For example, US GAAP defines acquisition costs as those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. Under US GAAP, acquisition costs are capitalised and amortised over the term of the contract. In the case of acquisition costs, the issue is whether the acquirer should recognise a separate asset for deferred acquisition costs incurred by the acquiree or would the acquirer include them in the intangible asset presented under the expanded presentation. Consider the following example:

> Acquirer A acquires in a business combination a portfolio of insurance contracts. The fair value of the insurance contracts is CU 70. The acquirer chooses the expanded presentation according to paragraph 31 of IFRS 4. The liability is measured in accordance with the acquirer's accounting policies at CU 100. The acquiree had capitalised acquisition costs of CU 10. Should the acquirer present:
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> - an intangible asset of CU 30; or
> - an intangible asset of CU 20 and deferred acquisition costs of CU 10?

14. The FASB staff recommends that all amounts that are recognised in accordance with Statement No. 60 for acquired insurance contracts should be accounted for by the acquirer as newly acquired or assumed business at the date of acquisition. The FASB staff believes this treatment to be consistent with the accounting for other assets acquired and liabilities assumed in a business combination. As a consequence, the acquiree's preacquisition balances, such as its deferred acquisition costs, would not be carried forward and presented in the acquirer's financial statements. The FASB staff believes furthermore that in a business combination the acquiree's deferred acquisition costs would likely be replaced by a customer or contract related intangible asset which would also be measured at fair value. The FASB staff will present its recommendation to the FASB on 18 April 2007.

15. IFRS 4 does not prescribe a specific accounting treatment for balances previously recognised by the acquiree (ie acquisition costs) in a business combination. The IASB ED did not propose changing IFRS 4 and respondents to the exposure draft did not request clarification on this issue. We recommend therefore that the IASB not prescribe a specific accounting treatment for deferred acquisition costs in phase II of the business combinations project.

16. ***Does the Board agree that phase II of the business combinations project should not specify whether the acquirer should present pre-acquisition contract balances of the acquiree as a separate asset or should include them in the intangible assets presented using the expanded presentation?***

Issue 3 – Clarification of the illustrative example

17. The FASB decided to clarify the wording in the illustrative example on the accounting for insurance contracts acquired in a business combination included in paragraph A49d of the FASB ED by noting that, in addition to the fair value intangible asset, other customer/contract based intangible assets also may require recognition.

18. The staff notes that paragraph 33 of IFRS 4 already states that IAS 36 and IAS 38 apply to customer lists and customer relationships reflecting the expectation of future contracts that are not part of the contractual insurance rights and contractual insurance obligations that existed at the date of the business combination. However, paragraph A49d of the IASB ED contains an example illustrating the relation between customer contract and customer relationship intangible assets and insurance contracts acquired in a business combination similar to that in the FASB ED. Like the FASB, the staff sees the question mainly as a drafting issue and intends to modify the wording in accordance with the FASB's decision. We believe that no further deliberations by the IASB on this issue are required.

ISSUES THAT COULD BE RELEVANT UNDER IFRSs, BUT FOR WHICH IFRS 4 DOES NOT PROVIDE DETAILED REQUIREMENTS

Issue 4 – Contingent commissions

19. Constituents requested clarification about whether acquired contingent commissions payable to brokers are intended to be included in the accounting for insurance contracts acquired in a business combination. Those commissions arise from contracts between an insurer and a broker, not directly from the insurance contract. The amounts paid could be related, for example, to premium volume generated by the broker for the insurer or the result from a book of business written by the broker. The FASB staff believes that contingent commissions represent contingent assets and recommends that they be remeasured periodically at fair value in accordance with paragraph 36 of the FASB ED which covers the accounting for contingencies including insurance contracts. The FASB will present this analysis to the FASB on 18 April 2007.

Issue 5 – Subsequent accounting for the fair value intangible asset

20. Constituents asked for guidance on the subsequent accounting for fair value intangible assets. On 13 February 2007, the FASB decided to require that fair value intangible assets be accounted for as a fixed amount determined at the date of acquisition and only adjusted for amortisation and impairment. The FASB staff will revisit this issue at the 18 April FASB meeting. After further research, the FASB staff believes that the issue should be linked to the question of what the nature of the fair value intangible asset (ie a contra-liability, a plug or a discount) is and recommends not changing current practice under US GAAP. As a consequence short-duration fair value intangible assets and long-duration fair value intangible assets would be accounted for differently. The short-term duration fair value intangible assets would be treated as a discount of the short-term insurance liability and be accounted for using a yield method like that described in Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases.* In contrast, a long-duration fair value intangible asset would be accreted

and amortised in accordance with the accounting for deferred acquisition costs required in Statement No. 60.

21. Paragraph 31b of IFRS 4 states that the subsequent measurement of the fair value intangible asset should be consistent with the measurement of the related insurance liability. BC149 of IFRS 4 summarises the IASB's basis for conclusion as follows:

> The intangible asset described above is generally amortised over the estimated life of the contracts. Some insurers use an interest method of amortisation, which appears appropriate for an asset that essentially comprises the present value of a set of contractual cash flows. However, it is doubtful whether IAS 38 *Intangible Assets* would have permitted its use. Therefore, the Board decided that this asset should remain outside the scope of IAS 38 and its subsequent measurement should be consistent with the measurement of the related insurance liability […].

Issue 6 – Guarantees for adequacy of insurance liabilities

22. EITF Topic D-54 provides guidance for reinsurance arrangements that are provided by the selling entity and that guarantee acquired liabilities for claims and claims adjustment costs. EITF Topic D-54 exempts seller's guarantees of claims liabilities from the retroactive accounting requirements of Statement No. 113. At its 13 February 2007 meeting the FASB discussed whether a seller's guarantee of the adequacy of claims liabilities should be accounted for as a guarantee or a reinsurance contract. The FASB asked the staff to conduct further research on this issue. The FASB staff believes that the EITF intended the guarantee to be accounted for as all other guarantees and that any recoveries should be considered contingent assets under the FASB ED. The FASB staff will present its recommendation to the FASB on 18 April 2007.

Staff recommendation and question to the Board

23. The staff believes that issues 4-6 might also be applicable to IFRSs. However, we believe that those issues are more specific than the current degree of detail of the requirements stated in IFRS 4. The staff recommends therefore, not to address issues 4-6 in phase II of the business combinations project. The staff believes that

this recommendation does not prejudge whether Issues 4-6 should be addressed in phase II of the IASB's project on insurance contracts.

24. ***Does the Board agree that phase II of the business combinations project should not address issues 4-6?***

ISSUES THAT ARE ADDRESSED BY MORE GENERAL PRINCIPLES

Issue 7 – When does a reinsurance arrangement qualify as a business combination?

25. Constituents questioned how loss portfolio transfers or other transfers of an insurance business by contract would fit into the definition of a business combination and requested clarification on the accounting for those situations. Loss portfolio transfers generally are indemnity reinsurance arrangements that reinsure claims liabilities for existing insurance contracts to the assuming company. They can be used to acquire a business when less than an insurance entity is being acquired.

26. The FASB affirmed that the general guidance in the FASB ED for determining whether a transaction is a business combination or an asset purchase is sufficient to determine whether a reinsurance arrangement was entered into to effect a business combination or simply to indemnify the reinsured.

Issue 8 – Mutual insurance entities

27. Some constituents argued that mutual insurance entities have unique characteristics which distinguish them from other entities that are required to apply the acquisition method. Those constituents believed that mutual insurance entities should be exempted from the acquisition method. The FASB did not identify unique characteristics of mutual insurance entities that would justify a treatment different from that of other mutual entities and affirmed that mutual insurance entities are required to apply the acquisition method for combinations of mutual insurance entities.

28. In December 2006 the IASB affirmed the proposal in the exposure draft to include mutual entities in the scope of the revised business combinations standard. Thus, the acquisition method would apply to combinations between mutual entities.

Issue 9 - Fair value measurement

29. Some constituents believe that insurance contracts should be excluded from the fair value measurement requirements of the FASB ED. The FASB observed that even under existing US GAAP an acquirer in a business combination needs to fair value acquired insurance contracts. Hence, the FASB affirmed the guidance in the FASB ED that fair value measurement is required for insurance contract assets and liabilities at the date of acquisition.

30. The staff notes that the IASB discussed this issue in phase I of its project on insurance contracts. Paragraph BC153 of IFRS 4 states:

> Some respondents requested an exemption from fair value measurement for insurance liabilities assumed in a business combination. They argued that there is still too much uncertainty about how fair value should be defined and determined. However, insurers have apparently been able to cope with the existing requirements in IFRSs and in national standards. The Board saw no compelling reason for a new exemption.

Issue 10 – Classification of an insurance contract

31. Constituents asked that the final US GAAP business combinations standard clearly state that the classification of an insurance contract is not to be reassessed as of the acquisition date unless the terms of the insurance contract are modified as a result of the business combination. At the 18 April FASB meeting, the FASB staff will recommend that all amounts that are recognised in accordance with Statement No. 60 should be accounted for by the acquirer as newly acquired or assumed. However, the FASB staff also recommends that the issue of classification should be considered in the larger context of Agenda Paper 2B *Classification and Designation of Assets, Liabilities and Equity Instruments Acquired or Assumed in a Business Combination* addressing the subject at this meeting.

Staff recommendation and question to the Board

32. The staff believes that issues 7-9 are addressed by more general principles in phase II of the IASB's business combinations project. Issue 10 will be discussed at the IASB's April meeting. The staff recommends that issues 7-10 should not be revisited for insurance contracts acquired in a business combination.

33. ***Does the Board agree that issues 7-10 should not be revisited in the specific context of insurance contracts acquired in a business combination?***

APPENDIX

ISSUES THAT ARE NOT RELEVANT UNDER IFRSs

Issue 11 - Insurance contracts covered by the guidance in the exposure draft

34. Paragraph 36 of the FASB ED identifies the contracts within its scope by providing a list of insurance-specific US standards. In response to comments, the FASB has decided to rectify some omissions from that list. That list is not relevant to IFRSs. The staff believes that no further deliberations by the IASB are required on this matter.

Issue 12 – Liability adequacy test

35. Constituents asked the FASB to clarify the application of the premium deficiency test for a short-duration fair value intangible asset. In February 2007 the FASB affirmed the guidance in the FASB ED requiring the use of the premium deficiency test when testing the fair value intangible asset (for short- and long-duration insurance contracts) for impairment. The FASB decided further to provide for a voluntary accounting change to include investment income in the impairment testing for short-duration contracts. However, the FASB staff is concerned about the complexity associated with applying the premium deficiency test to both short- and long-duration fair value intangible assets and is recommending its use only for the long-duration intangible asset. The FASB staff also is recommending that the short-duration intangible asset be accounted for like a discount and essentially accreted using an effective yield method (Statement No. 91). Changes in the amount or timing of the related cash flows would require an adjustment to the yield.

36. Paragraph 15 of IFRS 4 states that an insurer shall assess at each reporting date whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. If that assessment shows that the carrying amount of its insurance liabilities is inadequate in the light of the estimated future cash flows, the entire deficiency shall be recognised in profit or loss. BC 95 and BC101 of IFRS 4 state:

BC95 The Boards intention was not to introduce piecemeal elements of a parallel measurement model, but to create a mechanism that reduces the possibility that material losses remain unrecognised during phase I. With this in mind, paragraph 16 of the IFRS defines minimum requirements that an insurer's existing test must meet. […]

BC 101 It is beyond the scope of phase I to create a detailed accounting regime for insurance contracts. Therefore the IASB does not specify:

(a) What criteria determine when existing contracts end and future contracts start;

(b) Whether or how the cash flows are discounted to reflect the time value of money or adjusted for risk and uncertainty;

(c) Whether the liability adequacy test considers both the time value and the intrinsic value of embedded options and guarantees

(d) Whether additional losses recognised because of the liability adequacy test are recognised by reducing the carrying amount of deferred acquisition costs or by increasing the carrying amount of the related insurance liabilities.

37. The staff believes that it is outside of the scope of phase II of the business combinations project to introduce further principles on how the liability adequacy test should be applied.

Issue 13 – Contract inception

38. The accounting for deferred acquisition costs according to Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*, and minimum death benefit liabilities according to SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Non-traditional Long-Duration and for Separate Accounts*, requires considering all activity back to the inception of the contract and retrospectively adjusting the balances. Constituents asked for guidance on whether the acquisition date should be considered to be the contract inception date for purposes of Statement No. 97 and SOP 03-1. At the 18 April FASB meeting, the FASB staff will recommend that all amounts that are

recognised in accordance with Statement No. 60 should be accounted for by the acquirer as newly acquired or assumed. Hence, they are recommending that the look-back period be only to the acquisition date.

39. IFRS 4 does not mandate a particular accounting approach for deferred acquisition costs or minimum death benefit liabilities. The staff believes therefore that no further deliberations by the IASB on this matter are required.