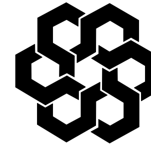

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**19 April 2007, London**
Project:	**Business Combinations II**
Subject:	**Insurance Contracts – FASB Memorandum (Agenda Paper 2G)**

OBJECTIVE OF THE MEETING

The June 30, 2005 FASB Exposure Draft, *Business Combinations,* includes specific guidance about accounting for insurance contracts acquired in a business combination. At this Board meeting, the staff is seeking the Board's views on issues raised by respondents to the Exposure Draft.

ISSUES FROM COMMENT LETTERS AND STAFF RECOMMENDATIONS

The issues below were raised by respondents who commented on the guidance specific to insurance contracts in the Exposure Draft. Some additional guidance also was requested by those respondents. Comments on the Exposure Draft that also are applicable to noninsurance entities are not discussed here because they are being addressed in other deliberations.

Issue 1: The guidance in paragraph 36(b)(2) of the Exposure Draft refers only to insurance contracts accounted for under FASB Statement No. 60, ***Accounting and Reporting by Insurance Enterprises.*** **Should insurance contracts covered by other authoritative guidance also be included in the scope of the insurance contract accounting guidance in the final Statement on business combinations?**

The staff believes that this was a drafting oversight and recommends that the scope for the insurance contract accounting guidance in the final Statement include all assets and liabilities related to contracts covered by Statement 60, FASB 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,* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* and FASB Statement No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts,* as well as other contracts related to the business of insurance. That would include acquired reinsurance recoverables, balances such as unearned revenue, and balances related to contingent commissions.

Issue 2: Reinsurance arrangements are used to indemnify a reinsured but also may be used to "sell" an insurance business (for example, a book of business) to an insurer or reinsurer. Is special guidance required for determining when a reinsurance arrangement qualifies as a business combination?

The staff believes that the guidance in the Exposure Draft for distinguishing between a business combination and an asset purchase is sufficient for determining whether a reinsurance arrangement is obtained for indemnification or to effect a business combination. Also, the staff has been unable to identify any additional criteria specific to reinsurance arrangements that would be helpful in making such a determination.

Issue 3: Transfer of significant insurance risk is required for a contract to be accounted for as insurance (rather than as a deposit). Should the risk transferred by an insurance contract be reevaluated at the date of acquisition?

The evaluation of risk transferred by an insurance contract is generally made only at the inception of an insurance contract. Absent a significant amendment to the contract as a result of an acquisition, the staff believes that the determination of whether significant insurance risk has been transferred should be made only at contract inception. Similar classification questions can arise for other contracts such as leases, which are addressed in paragraph 38 of the Exposure Draft:

> …a lease of the acquiree (regardless of whether the acquiree is the lessee or lessor) retains the lease classification determined by the acquiree at the lease inception, unless the provisions of a lease are modified as a result of the business combination in a way that would require the acquirer to consider the revised agreement a new lease agreement….

Accordingly, the staff supports developing broad, principles-based guidance for contracts when the accounting is based on contract characteristics that may be changed during an acquisition.

Issue 4: Certain long-duration contract balances are periodically adjusted based on current estimates of a book of contracts' profitability over the life of that book of contracts. For example, the total amortization to date of unearned revenues for universal-life type contracts is adjusted if actual experience or other evidence suggests that earlier estimates of expected gross profits should be revised. The issue is whether the contract's original inception date or the date of acquisition should be used for making such retrospective measurements for periods after the date of acquisition.

The "inception" date chosen will affect both the GAAP balances established for the GAAP basis accounts at the date of acquisition and the accrual/amortization rates to be used for future periods. Assuming the acquirer's assumptions are similar to those of the acquiree and that the original contract inception date is retained, the account balances at the date of acquisition should be similar to the amounts previously carried by the acquiree. If the date of acquisition is set as the contract inception date, accruals will be set to zero and a new unearned revenue amount recalculated (along with new amortization factors). The staff recommends that the contract inception date be used for

determining such balances. Otherwise there could be a significant discontinuity in accounting for contracts that presumably are being accounted for under current GAAP principles. The amount of the fair value intangible asset will be affected by the approach chosen since it is based on the balances at the date of acquisition. Subsequent cumulative adjustments to the balances under either approach would not affect the amount of the fair value intangible asset measured at the date of acquisition.

Issue 5: Which impairment test should be applied to the fair value intangible asset related to short-duration insurance contracts—that is, a premium deficiency (liability adequacy) test or a Statement 144 impairment test?

The purpose of the **short-duration contract** premium deficiency test is to ensure that the unearned premium liability (and, if elected, investment income on claims liabilities) is adequate to provide for future claims costs and recover any remaining unamortized deferred acquisition costs. In a broader sense, this is a **liability adequacy** test to ensure that the recorded insurance liabilities less any intangible assets are sufficient to cover estimated future contractual cash flows. FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* provides an impairment test that relies on the recoverability of an asset through undiscounted estimated cash flows and the measurement of any impairment based on the fair value of those cash flows. Some respondents suggested that the use of the premium deficiency approach be limited to intangible assets related to the acquired unearned premium and that Statement 144 testing be used for the other intangible assets. Since both approaches require cash flow testing, the staff believes that it is simpler to use the premium deficiency test for all contract-related intangible assets to avoid the need to allocate those cash flows for the two tests—one part for intangible assets being tested by the premium deficiency test and the second for the intangible assets being tested under the guidance in Statement 144. The concern with this approach is that some cash flows are not "double counted," that is, used to support recoverability of more than one asset. Therefore, the staff recommends using the premium deficiency test to avoid issues associated with allocating the cash flows. However, for companies not including investment income in their premium deficiency tests, see further discussion in Issue 5A.

Issue 5A: Should an authorized change in accounting be provided for companies that have previously not included investment income in their premium deficiency tests for short-duration insurance contracts?

Because the inclusion of investment income (on insurance liabilities) in the short-duration premium deficiency tests is optional under Statement 60, a company that has not elected to include investment income in that test might have an immediate write-off of a significant portion of the fair value adjustment (assuming the amount of the intangible asset is significantly affected by the discount on the claims liabilities). Although this change in accounting policy can be accomplished through a voluntary change in accounting, the final Statement could facilitate the accounting change by explicitly permitting such a change on adoption of the Statement (a so-called "free pass" similar to the reallocation of invested assets permitted by certain modifications to the guidance in FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*). However, acquirer accounting changes are not allowed under other accounting guidance included in the Exposure Draft and special transition guidance in this area would be inconsistent with that approach. Because of concern about the inconsistency within the Exposure Draft of allowing a "free pass" for the acquirer's accounting change needed for testing short-duration contracts, the staff understands that the Board might prefer allowing either approach—in concept, the impairment test results should be similar.

Issue 5B: Is any additional impairment guidance required for long-duration contracts?

EITF Issue No. 92-9, "Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company," already requires the value of business acquired (VOBA, also known as present value of future profits (PVFP or PVP)), an intangible asset often used in accounting for business combinations that include long-duration contracts, to be included in the long-duration premium deficiency test. However, in this case, both the future profits (the VOBA intangible) and the future cash flows are discounted so there is no measurement "mismatch." The future cash flows also include the estimated future premiums of the acquired long-duration contracts.

Accordingly, the staff believes that using the premium deficiency test for long-duration contracts is appropriate and that no further impairment guidance is necessary for those contracts.

Issue 6: How should the short-duration fair value intangible asset be accounted for?

> Approach A: A dynamic, accreting balance responding to changes in the related liability; or
>
> Approach B: A static amount determined at the date of acquisition and adjusted only for amortization and any impairment.

Some respondents believe that the components composing the intangible asset (for example, discounts and risk margins) should be considered independently in accounting for the intangible asset (accounting for it like a contra-liability that would effectively track as a dynamic (and perhaps current) fair value adjustment to the related liability). They believe that the discount should be accreted to the intangible asset over the estimated settlement period of the insurance contracts acquired and the risk margin amortized as risk is released. Consistent with maintaining a quasi-fair-value intangible asset, they believe that the accretion should be reported as a credit to claims expense income. They also believe that guidance is necessary for adjusting the discount and risk margin for changes in estimates of the timing and/or ultimate amount of claims to be paid.

Others suggest that the amount of the intangible asset should be determined at the date of acquisition and that the only future adjustments to that asset would result from amortization over the lives of the contracts and impairment. That static approach would negate the need for further guidance for accounting for the postacquisition intangible asset.

The staff recommends that the fair value intangible asset be static in nature. The use of an intangible asset was intended to simplify the transition between fair value and current GAAP and was not an attempt to maintain a fair value notion prospectively.

Issue 6A: Should the accounting for the long-duration fair value intangible asset be different from the short-duration accounting?

For long-duration contracts, some believe the fair value adjustment intangible asset should be amortized in accordance with Issue 92-9, which prescribes that VOBA be accounted for like deferred acquisition costs (which for long-duration contracts considers the assumptions used in calculating the benefit liability, including the accretion of interest). Therefore, they believe that no additional guidance is needed for long-duration contracts.

The staff believes that, unlike Issue 92-9, the long-duration fair value intangible asset also should be static in nature and adjusted only for amortization and any impairment.

Issue 7: Is clarification of the insurance example included in the Exposure Draft (paragraph A49(d)) needed to specify that, in addition to the fair value intangible asset, other customer/contract-based intangible assets (such as customer lists) may also require recognition?

Paragraph A49(d) includes somewhat confusing language that suggests there could be customer/contract related intangible assets at the date of acquisition that need to be recorded (in addition to the fair value intangible asset). The staff recommends editorial revisions to clarify that intent.

Issue 8: Should fair value be required for the measurement of insurance contract assets and liabilities at the date of acquisition, especially since there are no accepted procedures for measuring such elements?

The staff recommends that the fair value measurement requirement for insurance contract assets and liabilities be reaffirmed by the Board (this requirement in the Exposure Draft is not new). Although the IASB's current insurance contracts project is often cited as a reason for not requiring fair value measurement for insurance contracts today, that project ultimately may or may not lead to a fair-value-like measurement for insurance contracts. In any case, finalization of that insurance contract accounting guidance is many years off and not really pertinent to the fair value requirement in the Exposure Draft.

Issue 9: Should the acquisition method apply to combinations of mutual insurance entities?

One respondent suggested that mutual insurance companies be exempted from the business combinations guidance until the Boards further evaluate the "fresh-start" method. However, the staff believes that acquisition accounting applies to business combinations involving mutual insurance entities and other mutual entities, especially those that have shareholder-owned analogues. In any case, this is an issue that is being addressed for all mutual entities.

Issue 10: Should a seller's guarantee of the adequacy of acquired short-duration claims liabilities be accounted for as retroactive reinsurance?

The Exposure Draft would nullify EITF Topic No. D-54, "Accounting by the Purchaser for a Seller's Guarantee of the Adequacy of Liabilities for Losses and Loss Adjustment Expenses of an Insurance Enterprise Acquired in a Purchase Business Combination," and incorporate the accounting guidance from that Topic in a proposed footnote amending paragraph 22 of Statement 113. The footnote exempts certain guarantees of acquired short-duration claims liabilities from the accounting requirements of Statement 113 for retroactive reinsurance arrangements (that is, reinsurance of past events). Under retroactive reinsurance accounting, any gain resulting from such an arrangement is deferred and amortized over the contract claims settlement period. Because the insurance liability guarantee effectively reinsures existing claims liabilities arising from prior events, it normally would be considered a retroactive contract. However, the proposed footnote excludes certain of these guarantees from the retroactive reinsurance guidance. The staff believes that limited editorial revisions are needed to clarify the intent of the footnote. One respondent suggested maintaining the additional guidance in Topic D-54, guidance that the staff believes can be otherwise captured by the respondent if considered necessary. The staff believes that Topic D-54 should be nullified.

Issue 10A: If not retroactive accounting, which guidance in Statement 141 should be used to account for these guarantees?

The Exposure Draft proposes that such guarantees be accounted for in accordance with Statement 141. The question is which guidance in Statement 141 should apply: would the guarantee fall under paragraph 36 of the ED, and, if so, is the asset (recoverable) resulting from the guarantee (a) a receivable (a financial instrument) requiring fair value accounting at the acquisition date but not thereafter, (b) a Statement 5 contingent asset requiring fair value accounting at the acquisition date and thereafter, or (c) a contingency that is an asset arising from an insurance contract and thus requiring accounting consistent with the underlying insurance liabilities being guaranteed? The staff recommends alternative (c) and explicitly citing the guidance in paragraph 36(b)(2) as the appropriate guidance since the balances related to those guarantees are created by insurance contracts.

QUESTION FOR THE BOARD

Does the Board agree with the staff's recommendations?