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Introduction

1. This paper considers for in-force contracts at transition that were previously acquired through a business combination:

   (a) how to measure those contracts at transition. This is discussed in paragraphs 4-13; and

   (b) whether an entity should adjust retained earnings or goodwill to reflect gains or losses that result when the insurer first applies the forthcoming insurance contracts Standard. This is discussed in paragraphs 14-17.

2. The appendix contains background information on:

   (a) tentative decisions related to the measurement of insurance contracts at transition; and

   (b) IFRS requirements related to goodwill measurement.

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

Staff recommendation

3. The staff recommend that:

   (a) in applying the transition requirements for insurance contracts, an insurer should account for the in-force contracts that were previously acquired through a business combination using:

      (i) the date of the business combination as the date of inception of those contracts; and

      (ii) the fair value of those contracts at the date of the business combination as the premium received.

   (b) when an insurer first applies the forthcoming insurance contracts Standard to insurance contracts previously acquired through a business combination, any gains or losses should adjust retained earnings (rather than goodwill).

Staff analysis

How to account at transition for contracts that were acquired through business combinations?

4. The IASB tentatively decided that when an insurer first applies the forthcoming insurance contracts Standard, it should measure insurance contracts that it has originated using a modified retrospective approach. The rationale for retrospective application is that contracts written before and after transition should be comparable. (But because retrospective application would often be impracticable, the IASB decided to modify retrospective application and provided some simplifications).

5. This paper provides an analysis of whether an insurer should, on transition, measure contracts acquired through a business combination consistently with contracts originated by the insurer, as follows:

   (a) Paragraphs 6-7 discuss how does the forthcoming Standard treat contracts acquired through a business combination and those originated by the insurer; and

(b) Paragraphs 8-13 discuss how the transition requirements for contracts originated by the insurer could be applied to contracts acquired through a business combination.

How does the forthcoming Standard treat contracts acquired through a business combination and those originated by the insurer?

6. The forthcoming IFRS (consistent with the 2010 Exposure Draft (the ED)) treats the insurance contracts acquired through business combinations and those originated by the insurer as similar transactions and therefore proposes similar measurement. However, because of the specifics of the business combination transaction, the Standard uses the information available for business combination while maintaining consistency with the requirements in IFRS 3 *Business Combinations*. Those specifics are accounted for as follows:

   (a) the date of inception for those contracts is deemed to be the date of acquisition (ie. the date of the business combination). The staff believe that this is consistent with the recognition point for insurance contracts generally, which is the beginning of the coverage period (from the insurer's perspective).

   (b) the cash inflow for those contracts (ie premiums received) is deemed to be the fair value at the date of acquisition. Paragraph 142 of the Basis for Conclusions for the 2010 ED confirms that the fair value of the portfolio of contracts that were acquired through a business combination may be viewed as corresponding to the fair value of the consideration received (ie premiums received for contracts originated by the insurer).

7. The ED proposed that contracts acquired through the business combination would be measured in principle consistently with contracts originated by the insurer. The measurement requirements for contracts acquired through the business combination would take into account specifics of this transaction as noted in paragraph 6. Consequently, the ED (paragraph 40) proposed that those contracts are measured at the date of the business combination at the higher of the following:

(a) the fair value of the portfolio. The excess of that fair value over the present value of the fulfilment cash flows establishes the residual margin at initial recognition. This is consistent with recognising a residual margin for the gains on day one when recognising insurance contracts that the insurer has originated; or

(b) the present value of the fulfilment cash flows. If that amount exceeds the fair value of the portfolio, that excess increases the initial carrying amount of goodwill recognised in the business combination. This is consistent with measuring contracts originated by the insurer in the present value of fulfilment cash flows if this is higher than the present value of cash inflows. However, the difference is accounted for as goodwill (rather than as a loss in the statement of comprehensive income) because of the requirements in IFRS 3.

How the transition requirements could be applied to contracts acquired through a business combination?

8. As explained in the section above, the staff believe that the principle in the forthcoming Standard is that insurance contracts that are acquired through business combinations are measured in a similar way to those that were originated by the insurer. Consequently, if this principle is applied to transition, the requirements[1] for the contracts originated by the insurer should also apply to contracts acquired through business combinations. Those requirements state that for in-force contracts at the transition date, the insurer should:

(a) measure the current value of fulfilment cash flows;

(b) estimate the residual margin using the modified retrospective approach, which maximises the use of objective information. This would require estimating the residual margin at inception by comparing the risk-adjusted present value of cash outflows with the present value of cash inflows. As noted in paragraph 6(b), the insurer would use the fair value of the acquired portfolio of contracts that are in-force at the date

[1] Please refer to the Appendix for more details about the transition requirements for measuring the insurance contracts.

of transition as cash inflow related to those contracts (equivalent to premiums for contracts originated by the insurer); and

(c) estimate the locked-in discount rate at the date of inception (ie at the date of the business combination as mentioned in paragraph 6(a));

9. As noted in paragraph 8(b), to estimate the residual margin for contracts acquired through a business combination, the insurer would need to use the fair value of insurance contracts acquired that remain in force at transition date. The staff believe that for many contracts that fair value may be available because IFRS 3 requires insurers to estimate the fair value of the liabilities at the business combination date. However, for some contracts, fair value information might not be easily available, for example:

(a) for contracts that were acquired as part of a business combination that occurred before the date at which IFRS 3 (and its predecessor) was effective; and

(b) for business combinations, prior to the adoption of IFRS, which were accounted for using local GAAPs that do not account for assets and liabilities acquired at fair value.

10. Some may be concerned that when fair value at the business combination date is not available, the insurer would be required to objectively estimate it. (In general, IFRS prohibits estimating fair value retrospectively because it is very difficult to estimate it without using hindsight). The staff believe that lack of fair value information for some contracts at transition is similar to a situation in which the insurer does not have the information at the transition date about all the premiums that were received before the transition date. In this situation, according to the transition requirements proposed by the IASB for insurance contracts, the residual margin would be estimated by maximising the use of objective information available. This could include various estimation techniques, such as:

(a) estimating the residual margin by reference to the existing contracts, adjusting for different factors that might differentiate the margin in different periods; or

(b) estimating the residual margin by using historical assumptions about the profitability of similar contracts.

11. Those modifications to retrospective application were proposed because many insurance contracts are long term, and retrospective application would often be impracticable for those contracts. However, the IASB believed that, at transition, the margin should be estimated using all information available. Consequently, insurance contracts at transition and those written after transition would be more comparable than if no residual margin would be recognised for contracts written prior transition. Estimating the fair value of insurance liability (which is deemed to be premium received) at the business combination date would achieve the same objective.

12. Some might argue that it might be simpler to treat all contracts as having been originated by the insurer, because it would be not necessary to establish whether the contracts were originated by the insurer or were acquired through a business combination. This might be easier, especially if the business combination occurred long before the transition date and the portfolios have changed since that time — eg because some portfolios were merged or some parts might have been sold. However, the staff believe that accounting for contracts that were acquired through business combinations as if they were originated by the insurer would not provide the information that is relevant for those contracts. For example the locked-in discount rate at the origination date, rather than at the business combination date, would not portray the interest expense that the insurer, as the acquirer, included in the price charged for those portfolios.

13. The staff believe that the forthcoming Standard proposes to measure all insurance contracts using the same principles, irrespective of whether they were originated by the insurer or acquired through a business combination. Consequently, the same transition principles should be applied to measure all contracts at transition. Applying the IASB's tentative transition decisions to contracts acquired in a business combination transaction, the insurer should acknowledge specifics of this transaction, as follows:

    (a) the date of inception of those contracts is the date of the business combination; and

    (b) the fair value of those contracts is treated as the premiums received when measuring the insurance liability.

Question 1: How to account at transition for contracts that were acquired through business combination?
Does the IASB agree that, in applying the transition requirements for insurance contracts, an insurer should account for the in-force contracts that were previously acquired through a business combination using: (a) the date of the business combination as the date of inception of those contracts; and (b) the fair value of those contracts at the date of the business combination as the premium received?

Should the insurer adjust goodwill on transition to the forthcoming insurance contracts Standard?

14. When a business combination has occurred before the transition to the forthcoming insurance contracts Standard, an insurer might carry forward any goodwill balance in the statement of financial position. Such goodwill[2] would be measured consistently with the requirements of IFRS 3 (or IFRS 1)[3]. This section considers whether retained earnings or goodwill should be adjusted to reflect gains or losses that result when the insurer first applies the forthcoming insurance contracts Standard to insurance contracts previously acquired through a business combination.

15. The staff note that when an entity makes the transition to a new Standard when using IFRSs, any adjustments are taken against retained earnings and not against goodwill. This is also applicable for Standards that require retrospective application to measure the assets or liabilities on transition. The staff believe that:

    (a) any retrospective adjustment to goodwill that is meaningful would require revaluation of all assets and other liabilities together with the insurance liabilities acquired during the business combination;

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[2] Goodwill is defined according to IFRS 3 as “an asset representing the future benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised”.

[3] The appendix includes IFRS requirements related to goodwill measurement.

(b) the amount of goodwill is viewed as a point in time calculation that reflect estimates that were included in the consideration transferred and should not be updated if using hindsight would result in reporting different amount. This is consistent with IFRS 3 that allows adjusting the amounts recognised as a result of the business combination to reflect new information about the facts and circumstances that existed as of the acquisition date. Those adjustments needs to be done within a year and after that time, the entity could revise those amounts only to correct an error; and

(c) adjusting goodwill when making the transition to the forthcoming insurance contracts Standard would create an exception to transition requirements in other IFRSs. The staff do not believe that this exception is justified for the forthcoming insurance Standard.

16. Some might argue that the insurer should adjust the amount of the goodwill as calculated at the business combination date if new information implies that goodwill was understated or overstated. They reason that goodwill should be adjusted to reflect the retrospective application of forthcoming insurance Standard. They believe that the goodwill could be adjusted for the difference at the date of business combination between:

(a) the amount of previously calculated insurance contract liability amount that was part of the goodwill recognised; and

(b) the amount of the insurance contract liability at the business combination date, calculated using the general transition requirements (as recommended by the staff in Question 1).

17. However, the staff believe that this difference should not result in restatement of goodwill as initially recognised because of reasons stated in paragraph 15. Consequently, the staff recommend that an insurer should adjust retained earnings, instead of goodwill, for gains and losses that arise from the transition restatements related to contracts acquired previously through the business combination.

Question 2: Should an insurer adjust goodwill as a result of making the transition to the forthcoming insurance contracts Standard?

Does the IASB agree that, when an insurer first applies the forthcoming insurance contracts Standard to insurance contracts previously acquired through a business combination, any gains or losses should adjust retained earnings (rather than goodwill)?

Appendix: Related decisions and requirements

Tentative decisions related to the measurement of insurance contracts at transition

A1. The IASB tentatively decided[4] that when an insurer first applies the proposed Standard, the insurer should, at the beginning of the earliest period presented:

(a) measure the present value of the fulfilment cash flows using current estimates at the date of transition (ie as of the earliest period presented); and

(b) determine the single or residual margin through modified retrospective application of the new accounting principle to all prior periods maximising the use of the objective information. The insurer should:

(i) assume that all changes in estimates of cash flows between initial recognition and the beginning of the earliest period presented were already known at initial recognition; and

(ii) that the risk adjustment at inception is assumed to be equal to this at transition date.

(c) Determine the locked-in discount rate at inception through retrospective application when it is practicable. When it is not practicable the insurer shall determine the discount rate as follows:

(i) Calculate the discount rate in accordance with the Standard for a minimum of three years and, if possible, decide upon an observable rate that approximates the calculated rates. If there is no observable rate that approximates the calculated rate, then find the spread between the calculated rate and an observable rate.

(ii) Use the same observable reference point to determine the rate (plus or minus the spread determined in (a) if applicable) to be applied at the contract inception for contracts that were issued in the retrospective period.

[4] The discussions took place in September 2012, October 2012 and January 2013.

(iii) Apply the yield curve corresponding to that rate to the expected cash flows for contracts recognised in the retrospective period to determine the single or residual margin at contract inception.

(iv) Use the rate from the reference yield curve reflecting the duration of the liability for recognising interest expense on the liability.

(v) Recognise in other comprehensive income the cumulative effect of the difference between that rate and the discount rate determined at the transition date.

IFRS requirements related to goodwill measurement

A2. According to IFRS 3 (paragraph 32), the insurer would measure goodwill as an excess of the consideration transferred measured at fair value and the net of the identifiable assets and liabilities measured at fair value. According to paragraph 64, IFRS 3 was applied prospectively; consequently there were no restatements of the goodwill that was accounted for before IFRS 3 was effective[5]. Basis for Conclusion for IFRS 3 argues that 'applying the standards retrospectively would not be feasible'. Paragraphs 45-50 allows adjusting the amounts recognised as a result of the business combination to reflect new information about the facts and circumstances that existed as of the acquisition date. Those adjustments needs to be done within a year and after that time, the insurer could revise those amounts only to correct an error.

A3. For first time adopters, IFRS 1 (Appendix C) allows to elect applying IFRS 3 retrospectively to some or all business combinations that occurred before the date of transition to IFRSs. Paragraph C4(g) states that if an insurer does not elect to apply the IFRS 3 retrospectively, the insurer would carry over the balance of the goodwill accounted for using the previous GAAP, however:

[5] IFRS 3 was applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning or after 1 July 2009. Earlier application was permitted. However, this IFRS could have been applied only to the beginning of an annual reporting period that began on or after 30 June 2007.

(a) it should be adjusted for the effect of derecognition of the asset or liability that does not qualify for the recognition in accordance with IFRSs and that was previously subsumed in recognised goodwill; and

(b) it should be tested for impairment according to IAS 36 *Impairment of Assets* even if there is no specific indication to test it at the transition date.