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Acquiring insurance contracts

Transfers of insurance contracts and business combinations under IFRS 17 and IFRS 3

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Acquiring insurance contracts

What's the issue?

A company may acquire insurance contracts either via a transfer or via a business combination in the scope of IFRS 3 *Business Combinations* or under common control.

Under IFRS 17 *Insurance Contracts,* a company needs to assess insurance contracts acquired as at their date of acquisition, not their date of inception (or previous modification).

This applies for all contracts acquired via a business combination within the scope of IFRS 3 or a transfer.

What's the impact?

Companies may need to account for insurance contracts with similar characteristics differently. This is because it needs to assess them at different dates depending on whether they are acquired or issued.

An acquired contract may also no longer be in the scope of IFRS 17 and may need to be accounted for under another accounting standard – e.g. IFRS 9 *Financial Instruments*.

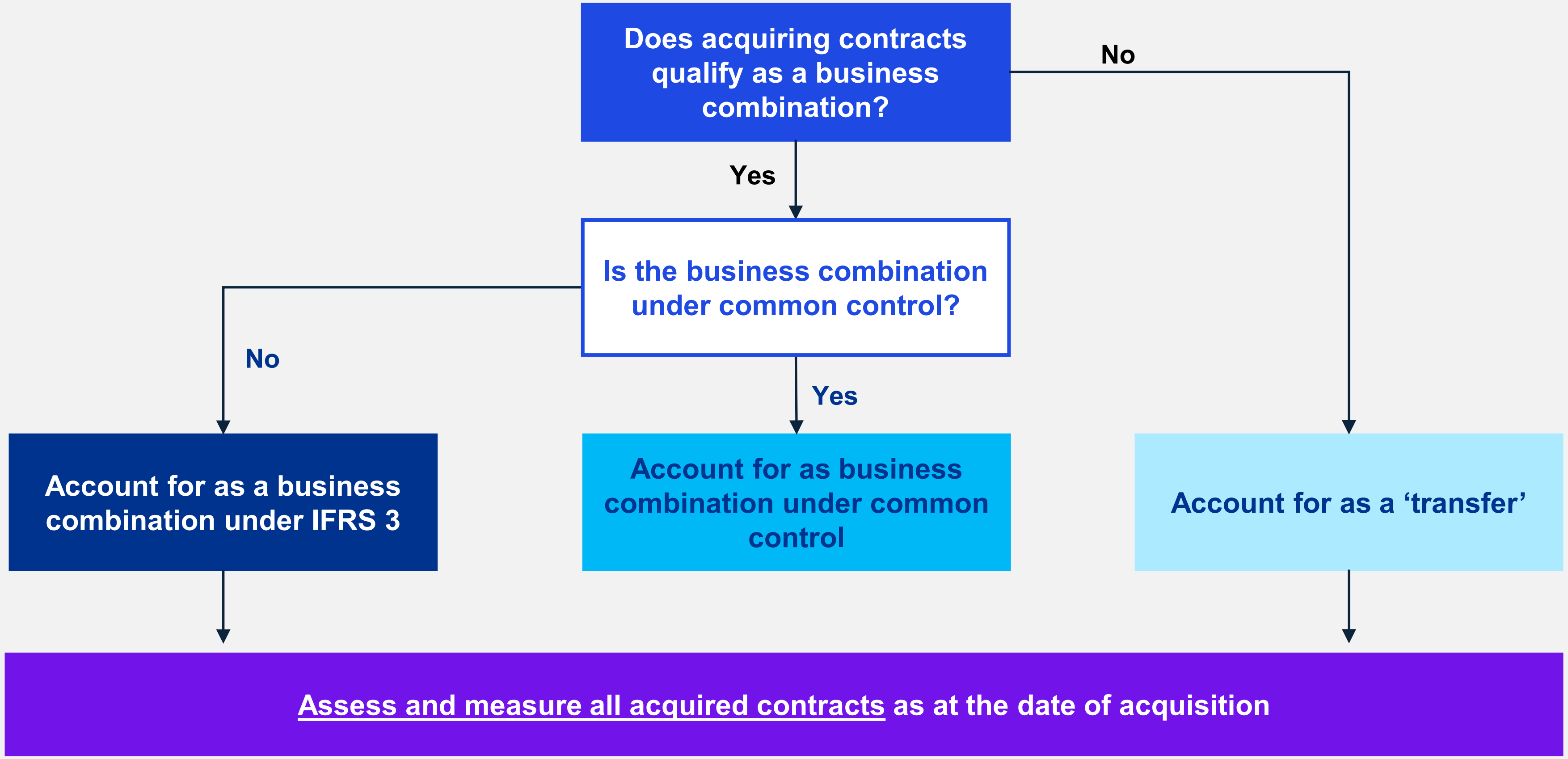
If a company acquires contracts through acquiring a contract-issuing subsidiary, then the acquirer reassesses the contracts as at the date of acquisition. Consequently, measurement differences between the parent and subsidiary may arise and cause a dual contractual service margin (CSM).

What's next?

- Identify all relevant data related to recent and planned acquisitions and assess the information you have available.
- Assess your systems and processes to ensure they can support the accounting requirements.
- Educate stakeholders on the financial reporting impacts when preparing for recent and future transfers of insurance contracts or business combinations.
- Involve specialists: transfers of insurance contracts or business combinations are often unique and complex.

Overview

Under IFRS 17, a company assesses insurance contracts acquired as at their date of acquisition.



Acquiring insurance contracts

Our guide sets out a step-by-step approach to accounting for acquired insurance contracts under IFRS® Accounting Standards.

01 Does acquiring contracts qualify as a business combination?

02 How are contracts acquired in a business combination measured?

03 Is the business combination under common control?

04 How are contracts acquired via a transfer measured?

05 Acquired vs issued contracts: How does classification and measurement differ?

06 Acquired vs issued contracts: Illustration

07 How is the fair value of acquired contracts determined?

08 What if a parent acquires a subsidiary that has issued contracts?

09 Acquiring contracts – Illustration

10 What next?

01 Does acquiring contracts qualify as a business combination?

IFRS 17 contains new requirements for acquired contracts. However, IFRS 3 continues to govern whether the acquisition qualifies as a business combination or a transfer. This first assessment drives the accounting under IFRS 17.

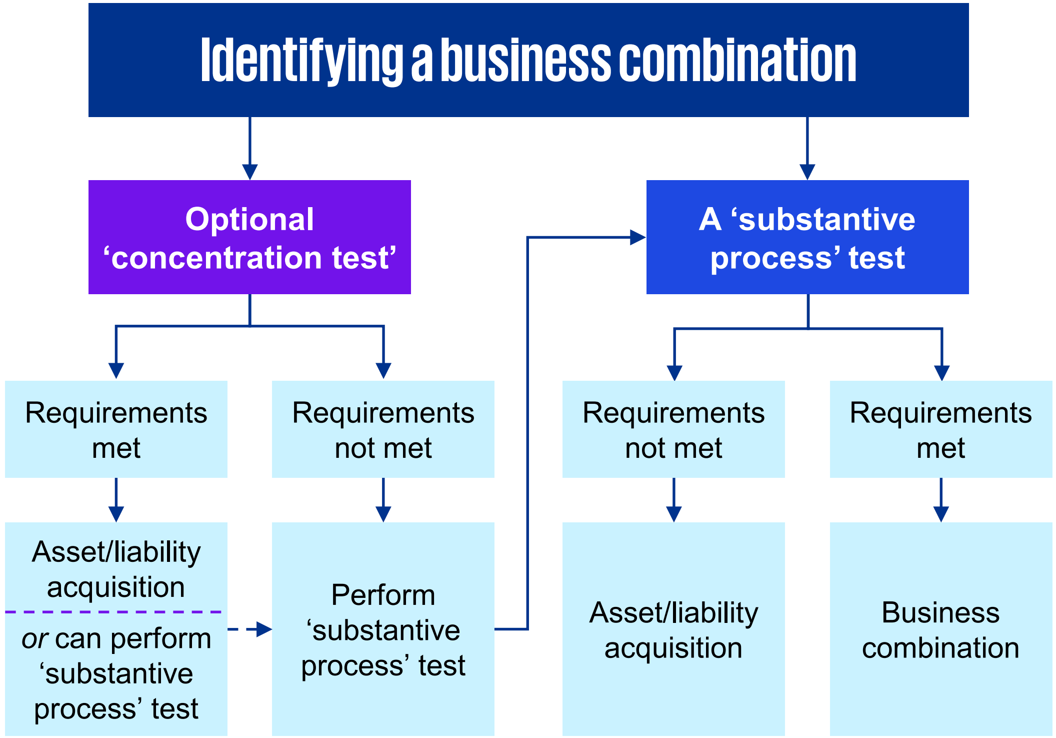
Under IFRS 3, the following tests are used to determine whether assets acquired and liabilities assumed constitute a business.

Optional ‘concentration test’ †

- Permitted test to assess whether a business may **not** exist.
- Cannot alone determine that a business combination **does** exist.

‘Substantive process’ test

- Test to determine whether a transaction is a business combination – i.e. the activities and assets acquired comprise at least an input and a substantive process, which together significantly contribute to the ability to create outputs.



What might constitute a substantive process?

Acquiring an organised workforce to manage the customer relationships and underwriting process would generally meet the criteria in the substantive process test.

† The optional concentration test looks at whether substantially all of the fair value of the gross assets acquired is concentrated in a single asset or group of similar assets.

02 How are contracts acquired in a business combination measured?

If the acquisition of contracts qualifies as a business combination under IFRS 3, then an insurer determines the identifiable assets acquired and the liabilities assumed as part of the business combination, and recognises them separately from goodwill as at the date of acquisition.

Insurance contracts are measured at their fair value as at their date of acquisition, which is treated as a proxy for premiums received.

IFRS 3 accounting

	IFRS 3 accounting
Insurance contracts	• Use consideration received or paid as a proxy for premiums received. • Consideration is the **fair value** of the contracts as at the date of acquisition.
Onerous insurance contracts	• Difference between the fulfilment cash flows and the consideration received or paid (i.e. fair value) is **part of the goodwill or gain on a bargain purchase** in profit or loss.
Loss recovery component (LRC) for group of reinsurance contracts held	• Recognise as a **reduction of goodwill or gain on a bargain purchase.** • Calculate by multiplying the loss component of underlying insurance contracts and the percentage of claims on the underlying contracts the acquirer expects to recover.

Insurance acquisition cash flow (IACF) assets	• Recognise the following **rights to obtain future insurance contracts** at fair value as at the date of the transaction:
	  • future contracts that are renewals of recognised contracts; and
	  • future contracts other than renewals, without paying IACFs that the acquiree has already paid and that are directly attributable to the related portfolio of insurance contracts.

03 Is the business combination under common control?

Business combinations under common control (BCUCC) may also occur. These are business combinations in which all of the combining companies or businesses are ultimately controlled by the same party or parties both before and after the combination.

BCUCC are not in the scope of IFRS 3, resulting in diversity in how the receiving company accounts for the transaction in its financial statements.

Some companies opt to use the acquisition method under IFRS 3; others use a book-value method.

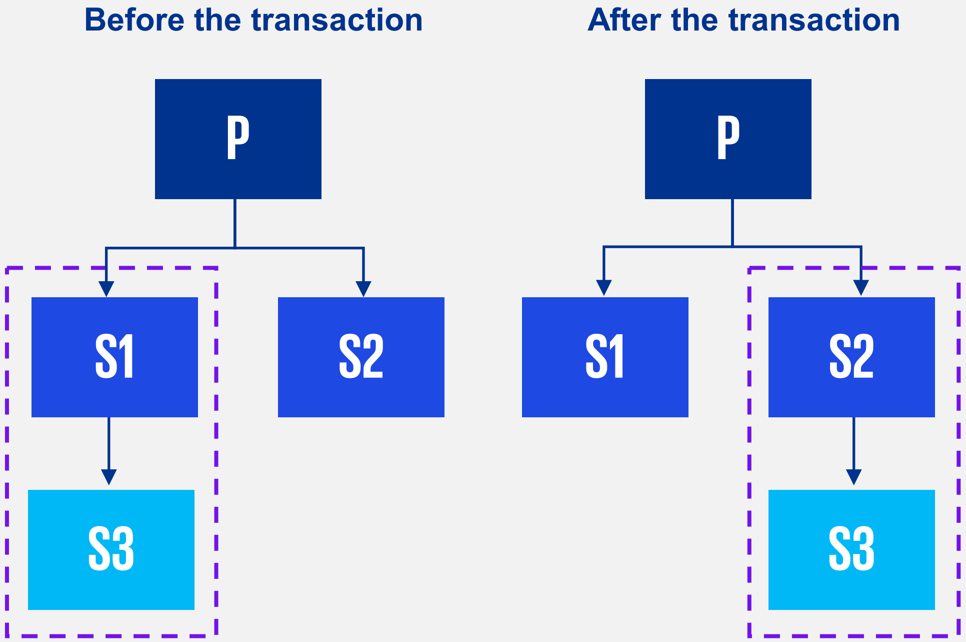
Under IFRS 3, differences in classification and measurement arise between the acquirer and acquiree's accounting.

What if there is a transfer under common control?

For transfers of insurance contracts under common control – i.e. transfers that are not business combinations – the requirements of IFRS 17 apply. However, any potential impacts of transactions with shareholders need to be considered in determining the appropriate accounting.

Example of a business combination under common control

Each of P, S1, S2 and S3 are businesses. Control of S3 is transferred from S1 to S2 (the receiving company). S2 and S3 (the combining businesses) are ultimately controlled by P before and after the transaction.



04 How are contracts acquired via a transfer measured?

Applying the concentration test to a transaction may result in a 'transfer' instead of a business combination.

Such transfers are measured at cost – i.e. the consideration received or paid for those contracts.

When a group of assets and/or liabilities are acquired together, the total cost is allocated to individual assets and liabilities based on their relative fair values as at the date of acquisition.

No goodwill or gain on a bargain purchase arises on the acquisition of an onerous insurance contract.

What if the sum of individual fair values of identifiable assets and liabilities differs from the transaction price in a transfer?

In these cases, the IFRS Interpretations Committee's November 2017 decision would apply to determine the initial measurement of the individual assets and liabilities.

Measuring contracts transferred

Insurance contracts	• **Use consideration received or paid** for the contracts as a proxy for premiums received (i.e. allocate consideration to the contracts based on their **relative fair values**). • The premiums received are then used as input in the fulfilment cash flows at the date of acquisition to determine the contractual service margin (CSM) of the group(s) of contracts.
Onerous insurance contracts	• Recognise the difference between fulfilment cash flows (if higher than consideration) and consideration received or paid (i.e. relative fair value) as **a loss immediately in profit or loss.**
Loss recovery component for group of reinsurance contracts held	• Recognise the loss recovery component as **income in profit or loss.** • Calculate by multiplying the loss component of underlying insurance contracts and the percentage of claims on the underlying contracts the acquirer expects to recover.

IACF assets	• Recognise the following **rights to obtain future insurance contracts** at fair value as at the date of the transaction:
	  • future contracts that are renewals of recognised contracts; and
	  • future contracts other than renewals, without paying again IACFs that the acquiree has already paid and that are directly attributable to the related portfolio of insurance contracts.

05 Acquired vs issued contracts: How does classification and measurement differ?

For contracts acquired in either a business combination under IFRS 3 or a transfer, how a company classifies and measures those contracts may differ significantly under IFRS 17.

Classifying and measuring acquired contracts as at the date of acquisition can lead to significantly different outcomes for specific contract types, as follows.

Originated contract

- Issued by subsidiary
- Classified and measured **at inception (or modification)**

Acquired contract

- Acquired by parent
- Classified and measured as **at date of acquisition**

Example contract type		Classifying and measuring acquired contracts
		• Assessed as at date of acquisition • Not grouped with issued contracts
	Short-term with long-tail claims and in settlement period (see overleaf)	• Generally measured under the GMM* (including a CSM on claims incurred but not yet settled) instead of under the PAA*.
	Direct participating contract with little/no remaining participation	• Generally measured under the GMM instead of under the VFA*.
	Includes significant insurance risk at inception that no longer exists	• Classified and measured under applicable IFRS Accounting Standards – e.g. under IFRS 9 instead of IFRS 17.

* General measurement model; premium allocation approach; variable fee approach

06 Acquired vs issued contracts : Illustration

Fact pattern

Company J has a group of short-term contracts with long-tail claims in their settlement period, for which it has recognised a liability for incurred claims. These contracts are one-year-coverage liability insurance contracts. J issued these contracts five years ago and so the coverage period for these contracts has now expired.

J acquires a group of similar contracts that were also issued five years ago.

J determines the coverage period for the **contracts acquired** based on the claims development period starting from the **date of acquisition**. For the purpose of this example, assume that J expects this to be 15 years from that date.

Recognising a CSM for claims acquired in their settlement period

Calculating the CSM may be challenging for some companies if they have inadequate systems in place. This applies especially if, before an acquisition, all originated contracts qualified for the PAA and therefore no CSM calculation systems were required for measurement.

J assesses the contracts it acquires as at the date of acquisition and determines the following.

- **15-year coverage period:** J expects to discover the ultimate claims amount after 15 years.
- **GMM applies:** The acquired contracts are unlikely to be eligible for the PAA, due to the significant length of the time until the ultimate discovery of the claims amount is expected.
- **CSM:** J calculates this under the GMM.
- **Insurance revenue:** J recognises insurance revenue over 15 years for the acquired contracts, reflecting the consideration received to assume those contracts and the amount that J expects it will need to settle the claims acquired, excluding any investment component.
- **Changes in estimates:** Changes in claims development for the contracts acquired may adjust future profitability via changes in the CSM.

07 How is the fair value of acquired contracts determined?

Acquired insurance contracts are measured at their **fair value** as at their date of acquisition, which is treated as a proxy for premiums received.

Fair value is defined in IFRS 13 *Fair Value Measurement** as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

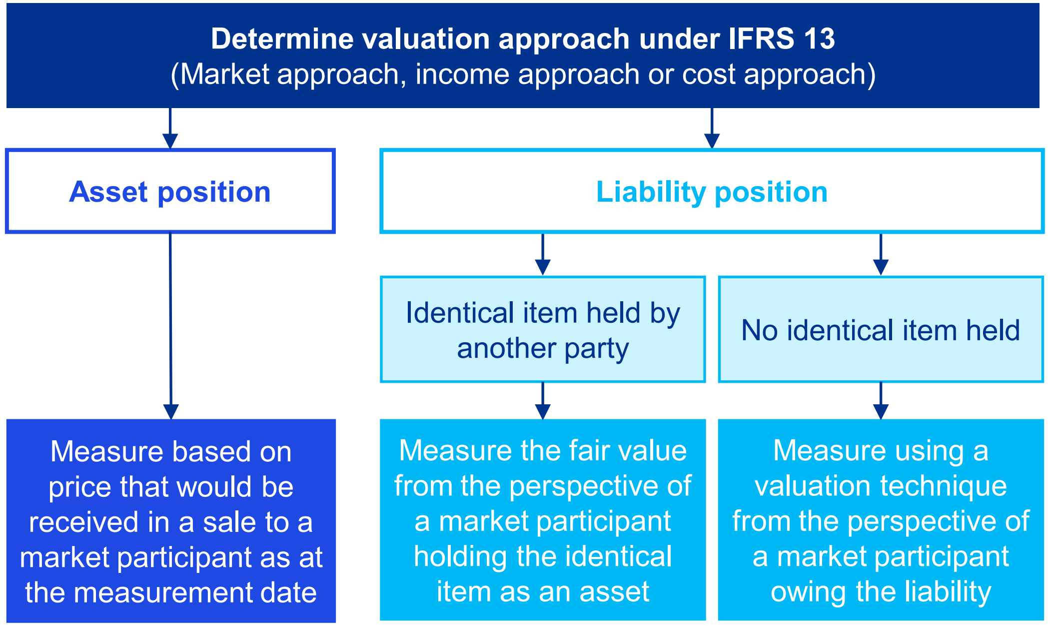
Of the three approaches mentioned under IFRS 13, insurers generally apply an **income approach**. This is because of the absence of quoted prices in an active market for identical contracts or groups of contracts.

Under the income approach, an insurer needs to apply judgement to determine the **inputs and assumptions** that a market participant† would use to price the contracts being valued, and the profit margin they would demand for taking on the contracts. Due to its complexity and requirement for significant judgement, involvement of actuarial or valuation specialists may be necessary.

How is the fair value of an acquired reinsurance contract determined?

The fair value of an acquired **reinsurance contract** in an asset position needs to be consistent with the perspective of a market participant that has issued the same underlying insurance contracts covered by the reinsurance contract held.

The contracts may be in an asset or a liability position when acquired. Different requirements apply as follows, depending on the contract's position.



* IFRS 13 is applied, except for the requirement that the fair value of a financial liability with a demand feature cannot be less than the amount payable on demand.

† A company excludes the value of expected future renewals that are outside the boundaries of the contract. This ensures consistency with the requirements for measurement of the fulfilment cash flows and the CSM. Differences may arise in other areas (e.g. allocated expenses, risk).

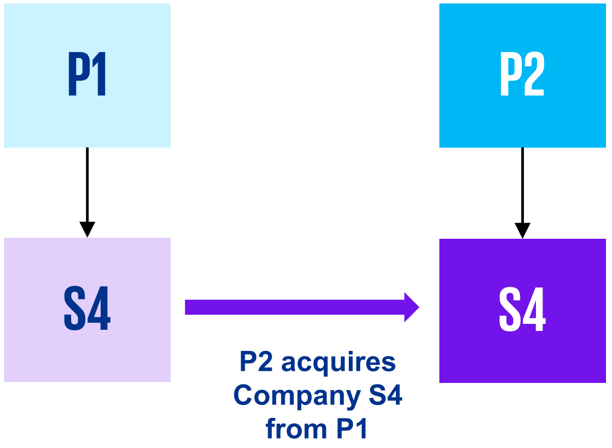
08 What if a parent acquires a subsidiary that has issued contracts?

If a parent company acquires a subsidiary that has previously issued insurance contracts, then:

- the **subsidiary** will continue to apply the general requirements of IFRS 17 to its insurance contracts; and
- the **parent company** will apply the specific requirements for insurance contracts acquired **as at the date of acquisition**.

This means that these contracts may be **classified and measured** differently in the consolidated financial statements and subsidiary's financial statements.

These differences may be significant, requiring additional explanation to stakeholders.



Acquired contract

- Acquired by parent
- Classified and measured as **at date of acquisition**

Originated contract

- Issued by subsidiary
- Classified and measured as **at date of inception (or modification)**

Is a dual CSM required?

Usually yes. A dual CSM applies when the measurement of the CSM for the same group of insurance contracts differs between the parent and the subsidiary. It is likely that the classification could change upon acquisition, which will also impact the CSM measurement. This will impact group data and system requirements and may require explaining to stakeholders.

09 Acquiring contracts: Illustration

Fact pattern

- On 31 December 2024, Company C acquires, among other assets and liabilities, a group of insurance contracts that have been in force for 10 years.
- C determines that the acquisition is a business combination.
- The fair value of the liability for these contracts at the transaction date is 30. On the date of acquisition, C estimates that the fulfilment cash flows are 20.
- Although the contracts have been in force for 10 years, C initially recognises and measures them as if they had been issued on 31 December 2024. This is because IFRS 3 requires that they are assessed as at their date of acquisition.
- Assume the following:
  - The fair value of investments is 40.
  - The fair value of intangible assets identified on acquisition is 20.
  - The fair value of IACF assets is 10.
  - The consideration paid for the business combination is 80, which is financed by bank borrowings.

C calculates the CSM of the acquired contracts as follows.

	Amount
Insurance contract liability at fair value	30
Fulfilment cash flows	20
Contractual service margin	**10**

C records the following consolidation entries as at the date of acquisition.

	Debit	Credit
Goodwill	40	
Intangible assets	20	
Investments	40	
IACF assets	10	
Insurance contract liability on initial recognition		30
Bank borrowings		80

10 What next?

Identify acquisitions

… including identifying the date of acquisition and the information available for determining how to account for the transaction.

Assess systems and processes

… to ensure they can accommodate accounting for these contracts – e.g. being able to maintain separate sets of records (i.e. a dual CSM) for subsidiary and group reporting.

Plan for reporting changes

… including educating stakeholders on the financial impacts of IFRS 17 when preparing for future transfers of insurance contracts or business combinations.

Involve specialists

… because acquiring contracts can often be complex, require significant judgement and involve unique challenges. Ensure that the appropriate specialists are involved.

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