IFRS

STAFF PAPER

January 2020

IASB® meeting

Project	**Amendments to IFRS 17**
Paper topic	Business combinations—contracts acquired in their settlement period

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Purpose of the paper

1. This paper discusses staff analysis and recommendations about the feedback in response to the Exposure Draft *Amendments to IFRS 17* relating to contracts acquired in their settlement period. This paper follows the tentative decision of the International Accounting Standards Board (Board), at its November 2019 meeting, to consider further the feedback from outreach and comment letters on this topic.

Summary of staff recommendations

2. The staff recommend the Board retain, unchanged, the requirements in IFRS 17 *Insurance Contracts* for insurance contracts acquired in their settlement period in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3 *Business Combinations*.

Structure of the paper

3. This paper provides:
   (a) background on the topic;
   (b) an overview of the feedback; and
   (c) the staff analysis, recommendations and questions for Board members.
4. The appendix to this paper provides examples of applying the definition of an insured event.

Background

IFRS 17 requirements

5. An entity is required to assess whether a contract meets the definition of an insurance contract, and therefore whether the contract is within the scope of IFRS 17, based on facts and circumstances at:

   (a) inception of the contract if the entity issued the contract; or

   (b) the date the contract is acquired if the entity acquired the contract.[1]

6. An insurance contract is a contract under which the entity accepts significant insurance risk from the policyholder by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely effects the policyholder.

7. IFRS 17 defines an insured event as an uncertain future event covered by an insurance contract that creates insurance risk.

8. An entity classifies an insurance contract liability for an insured event as:

   (a) a *liability for remaining coverage* if the insured event has not occurred; and

   (b) a *liability for incurred claims* if the insured event has occurred.

9. The classification of an insurance contract liability as *a liability for incurred claims* or a *liability for remaining coverage* does not affect the determination of the fulfilment cash flows. However, the classification does affect the determination of the coverage period (ie the period over which the contractual service margin is recognised). Consequently, the classification affects whether some changes in the fulfilment cash flows adjust the contractual service margin and the allocation of the contractual service margin.

10. Some contracts, at inception or at the acquisition date, provide the policyholder with cover for events that have already occurred but the financial effect of which is still uncertain. Paragraph B5 of IFRS 17 specifies that such contracts meet the definition of an insurance contract because the insured event is the determination of the ultimate cost of claims. Applying IFRS 17 to such contracts, the insurance contract liability is

[1] In this paper 'contracts acquired' refers to contracts acquired in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3.

classified as a *liability for remaining coverage* until the date the ultimate cost of claims becomes known.

11. One example of such an insurance contract is a contract acquired by an entity after the occurrence of an event that triggered a valid claim by the policyholder but before the ultimate cost of the claim becomes known (referred to in this paper as ‘contracts acquired in their settlement period’).

Amendments to IFRS 17

12. When the Board considered proposing amendments to IFRS 17, it considered stakeholder concerns that applying IFRS 17 to contracts acquired in their settlement period would be a significant change from many existing insurance accounting practices. Applying many existing insurance accounting practices, the acquiring entity adopts the issuing entity’s:

    (a) classification of the contract as an insurance contract based on facts and circumstances at inception of the contract; and

    (b) classification as a *liability for incurred claims*, based on the insured event for the issuing entity.

13. As explained in paragraph BC207 of the Basis for Conclusions on the Exposure Draft, the Board:

    (a) considered an amendment to IFRS 17 suggested by stakeholders that would exempt insurance contracts acquired in a business combination from the general requirements for the determination of the insured event; and

    (b) disagreed with the stakeholders’ suggestion because, in the Board’s view, exempting insurance contracts acquired in a business combination from the general requirements for the determination of the insured event would create complexity for users of financial statements and reduce comparability with other transactions.

14. The Board, however, proposed reliefs on transition in response to stakeholder concerns that an entity may not have the information required to apply IFRS 17 retrospectively for insurance contracts acquired prior to the transition date. The proposed transition reliefs would permit an entity to classify a liability for insurance

contracts acquired in their settlement period prior to the transition date as a *liability for incurred claims* rather than a *liability for remaining coverage*. At its December 2019 meeting, the Board tentatively decided to finalise these proposed transition reliefs for contracts acquired.

Feedback

15. The Board did not ask a question on the requirements for business combinations in the Exposure Draft (other than relating to the proposed transition reliefs discussed in paragraph 14 of this paper and a proposed clarification to IFRS 3). Therefore, many respondents did not comment on those requirements.

16. A small number of respondents continued to express the view that determining the insured event for contracts acquired in their settlement period, as specified in paragraph B5 of IFRS 17,[2] is inconsistent with observations made by Transition Resource Group for IFRS 17 (TRG) members during a discussion about determining the insured event at the September 2018 TRG meeting. At that meeting, TRG members discussed two examples of insurance contracts issued (one that provides disability cover and one that provides fire cover) in which an insured event resulted in a claim with an uncertain settlement amount (of an annuity paid after a disability event and the cost of rebuilding a house after a fire event). TRG members observed that the definition of an insured event in IFRS 17 allows an entity to use judgement when determining whether the obligation to pay an annuity after a disability event and the obligation to pay the costs of rebuilding a house after a fire event are part of a *liability for remaining coverage* or a *liability for incurred claims* (see Appendix A to this paper).

17. Some respondents:

    (a) suggested the Board amend IFRS 17 to permit in all circumstances an entity to classify a liability for insurance contracts acquired in their settlement period as a *liability for incurred claims*; and

    (b) expressed the view that such an amendment would:

[2] See paragraph 10 of this paper.

(i) improve the usefulness of information provided by IFRS 17 by increasing comparability between insurance contracts issued by an entity and insurance contracts acquired by an entity;

(ii) reduce complexity and costs because such an amendment would be consistent with many existing insurance accounting practices; and

(iii) particularly, reduce complexity and costs for entities that would be required to apply the general model, rather than the premium allocation approach, only as a result of the requirements for contracts acquired.

18. When insurance contracts are acquired, IFRS 17 requires an entity to calculate the contractual service margin as the difference between the consideration received or paid and the fulfilment cash flows at the acquisition date. Most respondents that suggested the Board permit an entity to classify a liability for insurance contracts acquired in their settlement period as a *liability for incurred claims* (ie as contracts with no contractual service margin) did not suggest an alternative accounting treatment for that difference. One respondent suggested the Board should require an entity to recognise the difference as a deferred liability—but not as a contractual service margin—and to amortise that amount on a systematic basis. That respondent suggested the amount amortised should be presented in profit or loss separately from the insurance service result—rather than be presented as part of insurance revenue as required by IFRS 17.

19. A small number of respondents suggested the Board introduce a business model approach in IFRS 17. In this approach, an entity would classify a liability for contracts acquired in their settlement period as a *liability for remaining coverage* or a *liability for incurred claims* depending on whether the entity acquired those contracts for the purpose of making a profit from adverse development cover or for a different purpose, for example, as part of a wider growth strategy. Those respondents expressed the view that such an approach would be consistent with the classification of financial assets applying IFRS 9 *Financial Instruments*.

20. Two accounting firms commented on determining the insured event for contracts acquired in their settlement period. Those firms agreed with the requirements in IFRS 17. However, one of those firms expressed concern about a lack of comparability between revenue recognised from insurance contracts acquired before the IFRS 17 transition date (to which a transition relief to classify as a *liability for incurred claims* may apply) and revenue recognised from insurance contracts acquired after the IFRS 17 transition date (to which the general requirements in IFRS 17 to classify as a *liability for remaining coverage* apply). That firm suggested the Board amend IFRS 17 to require an entity to present insurance revenue recognised from contracts acquired in their settlement period as a reduction in insurance service expenses.

Staff analysis and recommendations

21. The Board, at its November 2019 meeting, decided to consider further whether feedback on the determination of the insured event applying IFRS 17 could affect the decision the Board took previously to retain, unchanged, the requirements for contracts acquired in their settlement period. The staff analysis in this paper considers separately:

    (a) the definition of an insured event.

    (b) the effects of respondents' suggestions to amend IFRS 17 on:

        (i) the measurement of insurance contracts acquired in their settlement period; and

        (ii) presentation in profit or loss.

    (c) other feedback:

        (i) entities that apply the premium allocation approach; and

        (ii) suggested business model approach.

Applying the definitions in IFRS 17

22. The definition of an insured event is fundamental to IFRS 17. A contract meets the definition of an insurance contract—and therefore is in the scope of IFRS 17—if, and only if, there is an insured event.[3] In addition, whether the insured event has occurred determines whether an insurance contract liability meets the definition of a *liability for remaining coverage* or a *liability for incurred claims*.

23. As explained in paragraph 16 of this paper, a small number of respondents continued to express the view that determining the insured event for insurance contracts acquired in their settlement period, as specified in paragraph B5 of IFRS 17, is inconsistent with observations made by TRG members during a discussion about determining the insured event for two examples of insurance contracts issued. Appendix A to this paper demonstrates how the definition of an insured event is applied:

    (a) in the two examples of insurance contracts issued discussed at the September 2018 TRG meeting; and

    (b) to insurance contracts acquired in their settlement period.

24. The staff observe that paragraph B5 of IFRS 17 does not prescribe specific requirements for determining the insured event in insurance contracts acquired in their settlement period. Instead, that paragraph simply explains how the general requirements for determining the insured event apply to some contracts.

25. Consequently, if the Board were to amend IFRS 17 to require an entity to classify contracts acquired in their settlement period as a *liability for incurred claims*, the Board would need to create an exception to the definition of an insured event. That exception would specify that for contracts acquired in their settlement period the insured event could be a known past event, rather than an uncertain future event. A consequence of that exception would be that an acquired contract could meet the definition of an insurance contract even though the entity does not identify itself as providing insurance coverage (ie cover for a specified uncertain future event).

[3] An entity shall also apply IFRS 17 to investment contracts with discretionary participation features it issues, provided the entity also issues insurance contracts.

26. In the staff view, any amendment that would change or create an exception to the definition of an insured event would be a fundamental change to the principles of IFRS 17. It would therefore not meet the criteria for amendments to IFRS 17 set by the Board. Nevertheless, paragraphs 27–34 of this paper set out the effects on measurement and presentation in profit or loss if the Board were to create an exception to the definition of an insured event for contracts acquired in their settlement period.

Measurement of contracts acquired in their settlement period

27. Applying IFRS 17 to insurance contracts acquired, the contractual service margin is calculated as the difference between the consideration received or paid and the fulfilment cash flows. If IFRS 17 were amended as suggested by some respondents, there would be no contractual service margin for contracts acquired in their settlement period. As such, the Board would need to add requirements to IFRS 17 to specify the accounting treatment for the difference between the consideration received or paid and the fulfilment cash flows.

28. One respondent suggested that the Board should require an entity to recognise the difference as a deferred liability—but not as a contractual service margin—and to amortise that amount on a systematic basis.

29. The contractual service margin requirements already provide a mechanism to account for the difference between the consideration and the fulfilment cash flows. The staff acknowledge that recognising a contractual service margin for insurance contracts acquired in their settlement period may add operational complexity for entities compared to some existing insurance accounting practices. However, in the staff view, creating a new alternative requirement to the contractual service margin requirements for entities in some circumstances—such as introducing a new 'deferred liability'—would add unnecessary complexity to the requirements of IFRS 17.

Presentation in profit or loss

30. Applying IFRS 17, the insurance revenue recognised from insurance contracts acquired in their settlement period would equal the consideration the entity receives on the acquisition. This is consistent with the general principle in IFRS 17 that total

insurance revenue equals the consideration for the contracts (premiums for insurance contracts issued). The following example demonstrates the presentation in profit or loss applying IFRS 17.

31. An entity acquires an insurance contract in its settlement period. At the acquisition date, claim amounts are uncertain, expected claims are CU300[4] and the risk adjustment for non-financial risk is CU50. The consideration received is CU370.

32. Applying IFRS 17, the contractual service margin is determined as CU20 (CU370 – CU350). Assuming events occur as expected, the following amounts would be recognised in profit or loss:

Insurance revenue [CU300 + CU50 + CU20]	370
Insurance service expenses [-CU300]	(300)
Insurance service result	**70**

33. If IFRS 17 were amended as suggested by some respondents and the insurance contract classified as a *liability for incurred claims*, there would be no insurance coverage and therefore no insurance revenue. Assuming events occur as expected, the following amounts would be recognised in profit or loss:

Insurance revenue	-
Insurance service expenses [CU50]	50
Insurance service result	**50**
Amortisation of deferred liability [CU20]	20
Profit or loss	**70**

34. In the staff view, reflecting the consideration received by the acquiring entity in insurance revenue provides useful information for users of financial statements that is consistent with the information provided by IFRS 17 for insurance contracts issued by the entity. The staff are not persuaded by the view that the alternative presentation in

[4] In this paper amounts are expressed in currency units (CU).

paragraph 33 of this paper would provide more useful information to users of financial statements.

Present insurance revenue as a reduction in insurance service expenses (suggestion in paragraph 20 of this paper)

35. Using the example in paragraphs 31–32 of this paper, the following illustration demonstrates the suggestion by one respondent to present insurance revenue recognised on contracts acquired in their settlement period as a reduction in insurance service expenses:

Insurance revenue	-
Insurance service expenses [CU300 + CU50 + CU20 - CU300]	70
Insurance service result	**70**

36. In the staff view, recognising insurance revenue on insurance contracts acquired in their settlement period as a reduction in insurance service expenses as set out in paragraph 35 of this paper would:

(a) reduce comparability between profits earned on insurance contracts issued and profits earned on insurance contracts acquired; and

(b) add unnecessary complexity to the presentation requirements.

37. The staff acknowledge concerns from one respondent that the proposed transition reliefs for insurance contracts acquired in their settlement period will reduce comparability between insurance revenue recognised from insurance contracts acquired before and after the IFRS 17 transition date. However, the staff note that:

(a) reduced comparability between transactions that occurred before and after a transition date is a common consequence of providing reliefs on transition to a new or amended IFRS Standard;

(b) transition reliefs are necessary when an entity does not have the information required to apply requirements retrospectively; and

(c) IFRS 17 requires an entity to provide disclosures in periods after transition that enable users of financial statements to identify the effect on the contractual service margin and insurance revenue from groups of insurance contracts measured at the transition date applying the modified retrospective approach or the fair value approach.

38. The staff view is that the benefit of maintaining comparability between insurance revenue recognised from insurance contracts *issued* and insurance contracts *acquired* after the transition date is greater than would be the benefit of maintaining comparability between insurance revenue recognised from insurance contracts acquired *before* and *after* the transition date.

39. Therefore, the staff think the Board should retain, unchanged, the presentation requirements for insurance revenue recognised on insurance contracts acquired in their settlement period.

Analysis of other feedback

Premium allocation approach

40. Some respondents expressed particular concern about the cost and complexity of recognising a contractual service margin for insurance contracts acquired for entities that would otherwise account for all their contracts applying the premium allocation approach, ie entities issuing short-term contracts eligible for the premium allocation approach. Because there is no contractual service margin applying the premium allocation approach, such entities may need to develop systems to apply the general model solely to account for contracts acquired in their settlement period.

41. The staff note that an entity acquiring an insurance contract in its settlement period—a period which could last many years—is in a different position compared to an entity issuing a short-term insurance contract with a small probability of a claim occurring. If the claim settlement period is expected to last many years, the acquirer has essentially entered into a long-term insurance contract.

42. Consider an example. Entity A issues an insurance contract that provides coverage in the event of a cargo ship sinking in a specified year. The probability that the ship will sink is 1/100,000. If the ship sinks, it could take 10 years to determine the ultimate

cost of claims for losses the policyholder incurs as a result of the sinking event. Entity A could determine:

(a) the insured event is the uncertain occurrence of the ship sinking, and therefore the coverage period is one year; or

(b) the insured events are the uncertain occurrence of the ship sinking and the determination of the ultimate cost of claims for the losses the policyholder incurs as a result of the sinking event, and therefore the coverage period could be up to 11 years.

43. Now assume that the ship sinks and, subsequently, Entity A is acquired by Entity B. Entity B has acquired an insurance contract knowing that there will be a large uncertain claim amount. Accordingly, at the time Entity B assumes the obligation, that entity is in a fundamentally different position than Entity A was when it issued the insurance contract with only a 1/100,000 probability of a claim occurring at all. For Entity B, there is no judgement required to determine the service that the entity is providing—it is providing insurance coverage for the uncertainty in the amount of claims.

44. In the staff view, requiring Entity B to account for such a contract applying the general model will provide useful information to users of financial statements about the contract Entity B has entered into based on facts and circumstances at the acquisition date.

Business model approach (suggestion in paragraph 19 of this paper)

45. As explained in paragraph 19 of this paper, some respondents suggested the Board add requirements to IFRS 17 to differentiate the accounting treatment of insurance contracts acquired in their settlement period depending on whether the entity acquired those contracts for the purpose of making a profit from adverse development cover or for a different purpose, for example, as part of a wider growth strategy. The staff think that adding such requirements would add unnecessary complexity to the Standard. The requirements in IFRS 17 measure any profit expected to be earned by the entity regardless of the entity’s intention.

46. In addition, the staff disagree with some respondents' view that adding such requirements would be consistent with the role of the business model in the classification of financial assets in IFRS 9.

47. The business model test in IFRS 9 is not based on the intention of the entity but is an assessment of fact. As a result of the business model assessment, the classification of financial assets in IFRS 9 is based (in part) on the manner in which an asset contributes cash flows to an entity. This is consistent with paragraph 6.49(b) of the *Conceptual Framework for Financial Reporting* which states that the relevance of information provided by a measurement basis is affected by how the asset or liability contributes to future cash flows. Thus, the business model test in IFRS 9 considers how an entity manages its financial assets to generate cash flows (in particular, whether that is by collecting contractual cash flows on the financial assets and/or through their sale).

48. In contrast, respondents suggesting a business model approach to determine the accounting for an acquisition of insurance contracts have suggested that a distinction be drawn based on the *reason for the acquisition*. Thus, unlike the business model test in IFRS 9, the focus would not be on the manner in which the liability contributes to future cash flows. Those respondents suggested, for example, different accounting for an entity that acquires insurance contracts for the purpose of making a profit from adverse development cover and one that makes the acquisition for the purpose of increasing the size of their portfolio—even if in both cases the entity will hold those contracts and pay claims.

49. Furthermore, the suggestion that a form of business model test should be determinative in the classification of these acquired insurance contracts is inconsistent with IFRS 9. The business model test in IFRS 9 is not in itself the basis for classification of financial assets—the classification also depends on the nature of the contractual cash flows.

Staff recommendation

50. In the staff view, the Board's conclusion in developing the Exposure Draft—that exempting insurance contracts acquired in their settlement period from the general requirements for determining the insured event would create complexity for users of financial statements and reduce comparability with the requirements for other transactions—continues to hold.

51. The staff recommend the Board retain, unchanged, the requirements in IFRS 17 for insurance contracts acquired in their settlement period in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3.

Question for Board members
Do you agree the Board should retain, unchanged, the requirements in IFRS 17 for insurance contracts acquired in their settlement period in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3?

Appendix A—applying the definition of an insured event

A1. This appendix demonstrates how the definition of an insured event is applied:

(a) in the two examples of insurance contracts issued discussed at the September 2018 TRG meeting; and

(b) to insurance contracts acquired in their settlement period.

A2. IFRS 17 defines an insured event as an uncertain future event covered by an insurance contract that creates insurance risk.

Two examples discussed at the TRG meeting

A3. At the September 2018 TRG meeting, TRG members considered an implementation question which asked whether, for two specified examples, an insurance contract liability would be classified as a *liability for remaining coverage* (for insured events that have not yet occurred) or a *liability for incurred claims* (for insured events that have already occurred).

Disability cover

A4. The first example considered by TRG members was an insurance contract issued that requires an entity to pay an annuity after a disability event. TRG members observed that, for that example, the entity could determine that:

(a) the insured event is the uncertain event of the policyholder becoming disabled because of the occurrence of an accident/illness; or

(b) the insured events are:

(i) the uncertain event of the policyholder becoming disabled because of the occurrence of an accident/illness (ie the event that triggers valid claims); and

(ii) the uncertain event of the policyholder remaining disabled and eligible to claim (ie the determination of the ultimate cost of those claims).

Fire cover

A5. The second example considered by TRG members was an insurance contract issued that requires an entity to pay to the policyholder the costs of rebuilding a house after a fire event. TRG members observed that, for that example, the entity could determine that:

(a) the insured event is the uncertain occurrence of a fire; or

(b) the insured events are:

  (i) the uncertain occurrence of a fire (ie the event that triggers valid claims); and

  (ii) the uncertain costs of rebuilding the house damaged by a fire (ie the determination of the ultimate cost of those claims).

A6. The staff observe that in both examples considered by TRG members, the event that triggers a valid claim (ie the policyholder becoming disabled or the occurrence of a fire) meets the definition of an insured event. Therefore, the contracts meet the definition of an insurance contract irrespective of whether the entity assesses that the determination of the ultimate cost of claims is an insured event.

Contracts acquired in their settlement period

A7. An event that occurred before a contract was acquired by an entity cannot be an insured event for the entity because at the acquisition date there is no uncertainty as to the occurrence of that event. Accordingly, in contrast to the two examples considered by TRG members, for contracts acquired in their settlement period there is only one event that could be an insured event for the acquirer—the determination of the ultimate cost of claims.

A8. Therefore, for contracts acquired in their settlement period:

(a) if claims amounts are uncertain at the acquisition date, there is an insured event and the contract would meet the definition of an insurance contract.

(b) if claims amounts are known at the acquisition date, there is no insured event and the contract would not meet the definition of an insurance contract. Amounts payable to policyholders of those contracts would be accounted for as a financial liability applying IFRS 9.