Australian Government
Australian Accounting Standards Board

AASB Transition Resource Group for AASB 17 *Insurance Contracts*

Private Health Insurance (PHI) focus group discussions on Business Combinations

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Potential implementation question

The implementation question addressed in this paper is how to interpret the AASB 17 requirements on transition to AASB 17 for PHI contracts acquired as part of a transfer or business combination, as defined in AASB 3.

Paragraph of IFRS 17 *Insurance Contracts*

Relevant sections of AASB 17 Paragraphs 5, 3, B3, B4, B5, B93, B94, B95, Appendix A – refer Appendix B for extracts

Analysis of the question
The analysis of the question should include a detailed description of the different ways the new Standard may be applied, resulting in possible diversity in practice.

Question: is the approach adopted by the PHI focus group consistent with other market participants? Refer Appendix A which sets out a summary of the discussions of the PHI focus group.

Is the question pervasive?
Explain whether the question is expected to be relevant to a wide group of stakeholders.

Paper is applicable to PHI applying PAA and has potential application to any insurers acquiring contracts prior to transition to AASB 17.

Appendix A

Background to question

Under AASB 17, insurance contracts that are acquired in a business combination, as defined by AASB 3 *Business Combinations*, or through a transfer of insurance contracts are treated as if they had been issued by the acquirer at the date of the acquisition transaction. In summary this means:

Recognition - There is no presumption that a contract is an insurance contract at the acquisition date, even if it had been classified as such by the seller at inception.

Classification - Contracts that were determined to be insurance contracts at the time that they originated but which, at the acquisition date, no longer transfer significant insurance risk, would not be in the scope of AASB 17 for the acquirer. Note the IASB provides relief from this on transition.

Measurement - For PAA eligibility, the contract boundary of the acquired contract is assessed from the acquisition date, not the original contract boundary start date, and coverage is the period until claims are settled.

Grouping - The determination of the portfolios and groups to which the acquired insurance contracts belong also occurs at the acquisition date.

Onerous contract assessment - If facts and circumstances indicate that the fulfilment cashflows are in a net outflow, a loss component should be recognised from the acquisition date.

In relation to insurance contracts acquired as part of a transfer or business combination as defined in AASB 3:

- For acquired contracts, consideration is deemed to be the contract's fair value at the date of transaction date, as defined in AASB 13 *Fair Value Measurement*. The consideration received or paid for the contracts is treated as a proxy for the premiums received for measurement purposes under AASB 17.
- AASB 17 requires the recognition of an acquisition asset for acquisition costs paid by the acquiree.
- Other intangible assets currently recognised under AASB 138 *Intangible Assets* (e.g. potentially some assets related to branding, customer lists/relationships and distribution agreements) will be recognised under AASB 17 if, and only if, they meet the definition of insurance acquisition cashflows

Application of standard

1. **Classification of acquired contracts as insurance contracts**

Accounting requirement
AASB 17 defines an insurance contract as a contract under which one party (the issuer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder (paragraph AASB 17.B3 to B5).

There is no presumption that a contract is an insurance contract at the acquisition date, even if it had been classified as such by the seller at inception. However, note that the IASB provided relief relating to classification of insurance contracts acquired through a business combination or acquisition of contracts prior to 1 January 2023.

Contracts that were determined to be insurance contracts at the time that they originated, but which, at the acquisition date, no longer transfer significant insurance risk, would not be in the scope of AASB 17 for the acquirer after 1 January 2023.

Application to PHI – summary of discussions
Acquired PHI policies are classified as insurance contracts if there is uncertainty in how insurance

risks will eventuate at the date of acquisition. For PHI, this is expected to apply to all contracts where the contract boundary has not ended as members can continue to make incurred but not reported (IBNR) claims after the acquisition date.

2. Assessed at date of transaction

Accounting requirement
Insurance contracts that are acquired in a transfer of insurance contracts or in a business combination, as defined by AASB 3, are treated as if they had been issued by the acquirer at the date of the acquisition transaction (AASB 17.B93).

Under AASB 17.B93, the insurer is required to apply the level of aggregation requirements, including the portfolios and groups based on the contractual terms, economic conditions and other factors as they exist at the acquisition date. Prior to AASB 17, AASB 3 contains an exception from this classification requirement for insurance contracts and stated that insurance contracts acquired in a business combination within its scope should be classified on the basis of the contractual terms and other factors at the inception of the contract rather than at the date of acquisition. This exception in AASB 3 is withdrawn when AASB 17 is applied.

Application to PHI – summary of discussions
For ***PAA eligibility***, the contract boundary of the acquired contract is assessed from the acquisition date, not the original contract boundary start date.

In determining ***the level of aggregation*** an entity will also need to determine the portfolios and groups to which the insurance contracts acquired belong on the acquisition date. Therefore, contracts originally issued more than one year apart may be included in the same cohort in the acquirer's financial statements. As such, groups of contracts identified by the acquirer may be different to the groups previously identified by the acquiree in their initial assessment.

3. Contracts acquired in the claims settlement period

Accounting requirement
AASB 17.B93 requires an entity to identify groups of insurance contracts as if it had entered into the contracts on the acquisition date. AASB 17.B5 also states that for insurance contracts that cover events that have already occurred, the insured event is the determination of the ultimate cost of those claims. Therefore, an entity treats insurance contracts transferred or acquired in a business combination that cover events that have already happened as providing coverage for the adverse development of claims.

Application to PHI – summary of discussions
Cashflows for claims acquired in the claim's settlement period may transfer insurance risk for:
- IBNR claims.
- Reported claims for which the claims amount can change after the acquisition date, i.e. for treatment that is ongoing or due to claims leakage recoveries.

However, if the claim is fully processed and the remaining liability is only due to the timing of payment, then there is no transfer of insurance risk and the balance is not in scope of AASB 17.

As acquired insurance contracts may transfer insurance risk to the acquirer, the acquirer's measurement of the liability for remaining coverage (LFRC) will be inclusive of any expected adverse claims development, refer to section 4 below. The acquirer recognises insurance service revenue in a rational and systematic manner over the claim development period.

There is no liability for incurred claims (LFIC) recognised on acquisition of the insurance contract. An LFRC is set up at acquisition and the LFIC and insurance service expenses are recognised on determination of the ultimate cost of claims

4. Allocation of consideration

Accounting requirement
For measurement purposes, AASB 17.B94 states that the consideration received or paid for the contracts is treated as a proxy for the premiums received. The consideration excludes any consideration for other assets and liabilities acquired in the same transaction.

For contracts acquired in a business combination, this consideration is deemed to be the contract's fair value at the date of transaction date, as defined in AASB 13 Fair Value Measurement, and that the consideration received or paid will need to be allocated to insurance contracts, other assets and liabilities outside the scope of AASB 17 and goodwill or gain on bargain purchase, if any.

Application to PHI – summary of discussions
For both transfer of assets/liabilities and for business combinations, identifiable assets acquired and liabilities assumed are measured at their acquisition date fair values.

Under AASB 17 there is no option available to split the value of the acquired insurance contracts into two components as was available in AASB 1023 13.3.1 - i.e. a liability in accordance with the insurer's accounting policies (local GAAP) and an intangible asset representing the difference between fair value and the value of that liability under the AASB 17 measurement model, commonly referred to as "Value of Business Acquired".

The fair value of an insurance contract is the amount a market participant would require to accept the obligation of an insurance contract excluding the effect that acquisition assets might have on the amount. Acquisition assets are identified separately (see section 5 below). The calculation of fair value of insurance contracts acquired has not changed under AASB 17.

For measurement purposes, the acquirer treats consideration paid, i.e. fair value, for the insurance contracts as a proxy for the premiums received when calculating the LFRC.

5. Accounting for acquisition costs and other intangible assets acquired through a business combination

Accounting requirement
Per AASB 17.B95E, when an entity acquires insurance contracts issued in an AASB 3 business combination or in the transfer of insurance contracts that do not form a business combination, it recognises an asset for insurance acquisition cash flows at fair value at the date of the transaction for the rights to obtain:

a) future insurance contracts that are renewals of insurance contracts recognised at the date of the transaction; and
b) future insurance contracts, other than those in (a), after the date of the transaction without paying again insurance acquisition cash flows the acquired business has already paid that are directly attributable to the related portfolio of insurance contracts.

Application to PHI – summary of discussions
- The recognition of assets under AASB 17.B95E (a) can be interpreted as the transfer of DAC from the seller to the acquirer.

  Assets in AASB 17.B95E (b) can be interpreted as all other acquisition costs (see definition in Appendix A) that have been paid by the acquiree which are not captured under AASB 17.B95E (a). Examples may include fees paid up front to an agent for a sale over the next financial year or call centre costs paid up front.

- Measurement - Any acquisition assets recognised under AASB 17.B95E (a) or (b) are measured at their acquisition date fair values.

  Insurers using PAA who acquire insurance contracts must still value acquisition cashflow assets under AASB 17.B95E(a) & B95E(b) in accordance with IFRS 13 even if their policy is to expense DAC.

It is possible for the fair value of acquisition assets to be determined as $nil on acquisition date, as assessed from the acquirer's perspective, if facts support a $nil value.

- Interaction with AASB 138 - Other assets which do not meet the requirements of AASB 17 B95E(a) & B95E(b) are accounted for under AASB 138 if recognition criteria of an intangible asset are met.

  Insurers need to consider if intangible assets currently accounted for under AASB 138 will be reclassified AASB 17.B95E(a) & B95E(b) on transition. An example may be a distribution agreement which may meet the definition of insurance acquisition cashflows if the agreement is directly related to selling, underwriting and starting insurance contracts.

  Assets which are not related to costs of selling, underwriting and starting insurance contracts , or need to be combined with other assets in order to sell insurance contracts may not meet the definition of insurance acquisition cashflows and continue to be accounted for under AASB 138. Examples may include branding, customer lists, customer relationships or a licence to operate in a certain jurisdiction.

- Amortisation of assets under AASB 138 may be allocated to insurance cashflows under AASB 17.B65 if they are related to the insurance contract.

  An acquisition cashflow which occurs before the commencement of the insurance contract may be classified under AASB 138, e.g. not in the process of starting a group of insurance contracts or not yet directly attributable to the portfolio of insurance contracts (see the definition in Appendix A). If intangible assets were originally classified under AASB 138, the balance would not move into AASB 17 when the contract starts (i.e. no reclassification) but the amortisation will be allocated to fulfilment cashflows if they are subsequently deemed to be directly related to the insurance contracts.

6. Onerous contracts

Accounting requirement
In accordance with paragraph B95A: If acquired insurance contracts issued are onerous, applying paragraph 47, the entity shall recognise the excess of the fulfilment cash flows over the consideration paid or received as part of goodwill or gain on a bargain purchase for contracts acquired in a business combination within the scope of AASB 3 or as a loss in profit or loss for contracts acquired in a transfer. The entity shall establish a loss component of the liability for remaining coverage for that excess and apply paragraphs 49–52 to allocate subsequent changes in fulfilment cash flows to that loss component.

Application to PHI – summary of discussions
AASB 17.18 states that an entity applying PAA shall assume no contracts are onerous unless facts and circumstances indicate otherwise. This is still applicable to insurance contracts acquired. If facts and circumstances indicate that the contracts acquired are onerous, then the difference between the consideration received/paid and the fulfilment cash flows is:

- For AASB 3 business combinations, recognised as part of the goodwill or gain on bargain purchase
- For the transfer of insurance contracts – recognised as a loss immediately in P&L,

and a corresponding loss component as part of the liability for remaining coverage.

Fulfilment cashflows may differ from fair values as fulfilment cash flows are an entity-specific measurement whereas fair value is measured from the perspective of a market participant

Appendix B

Extract of AASB 17 *Insurance Contracts*

Scope:
Paragraph 5
All references in AASB 17 to insurance contracts issued also apply to insurance contracts acquired by the entity in a transfer of insurance contracts or a business combination other than reinsurance contracts held.

Paragraphs 7
An entity shall not apply AASB 17 to:
…(f) contingent consideration payable or receivable in a business combination (see IFRS 3 *Business Combinations*)….

Extract of AASB 17 Definitions (Appendix A of AASB 17)

Insurance acquisition cash flows
Cash flows arising from the costs of selling, underwriting and starting a **group of insurance contracts** (issued or expected to be issued) that are directly attributable to the **portfolio of insurance contracts** to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or **groups of insurance contracts** within the portfolio.

Uncertain future event:
Paragraph B3
Uncertainty (or risk) is the essence of an insurance contract. Accordingly, at least one of the following is uncertain at the inception of an insurance contract:
(a) the probability of an insured event occurring;
(b) when the insured event will occur; or
(c) how much the entity will need to pay if the insured event occurs.

Paragraph B4
In some insurance contracts, the insured event is the discovery of a loss during the term of the contract, even if that loss arises from an event that occurred before the inception of the contract. In other insurance contracts, the insured event is an event that occurs during the term of the contract, even if the resulting loss is discovered after the end of the contract term.

Paragraph B5
Some insurance contracts cover events that have already occurred but the financial effect of which is still uncertain. An example is an insurance contract that provides insurance coverage against an adverse development of an event that has already occurred. In such contracts, the insured event is the determination of the ultimate cost of those claims.

Cash flows within the contract boundary (paragraph 34)
Paragraph B65
Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows within the boundary include:

- **(a)** premiums (including premium adjustments and instalment premiums) from a policyholder and any additional cash flows that result from those premiums.
- **(b)** payments to (or on behalf of) a policyholder, including claims that have already been reported but have not yet been paid (ie reported claims), incurred claims for events that have occurred but for which claims have not been reported and all future claims for which the entity has a substantive obligation (see paragraph 34)
- **(c)** payments to (or on behalf of) a policyholder that vary depending on returns on underlying items.
- **(d)** payments to (or on behalf of) a policyholder resulting from derivatives, for example, options and guarantees embedded in the contract, to the extent that those options and guarantees are not separated from the insurance contract (see paragraph 11(a)).

- **(e)** an allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.
- **(f)** claim handling costs (ie the costs the entity will incur in investigating, processing and resolving claims under existing insurance contracts, including legal and loss-adjusters' fees and internal costs of investigating claims and processing claim payments).
- **(g)** costs the entity will incur in providing contractual benefits paid in kind.
- **(h)** policy administration and maintenance costs, such as costs of premium billing and handling policy changes (for example, conversions and reinstatements). Such costs also include recurring commissions that are expected to be paid to intermediaries if a particular policyholder continues to pay the premiums within the boundary of the insurance contract.
- **(i)** transaction-based taxes (such as premium taxes, value added taxes and goods and services taxes) and levies (such as fire service levies and guarantee fund assessments) that arise directly from existing insurance contracts, or that can be attributed to them on a reasonable and consistent basis.
- **(j)** payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.
- **(k)** potential cash inflows from recoveries (such as salvage and subrogation) on future claims covered by existing insurance contracts and, to the extent that they do not qualify for recognition as separate assets, potential cash inflows from recoveries on past claims.
- **(ka**) costs the entity will incur:
  - (i) performing investment activity, to the extent the entity performs that activity to enhance benefits from insurance coverage for policyholders. Investment activities enhance benefits from insurance coverage if the entity performs those activities expecting to generate an investment return from which policyholders will benefit if an insured event occurs.
  - (ii) providing investment-return service to policyholders of insurance contracts without direct participation features (see paragraph B119B).
  - (iii) providing investment-related service to policyholders of insurance contracts with direct participation features.
- **(l)** an allocation of fixed and variable overheads (such as the costs of accounting, human resources, information technology and support, building depreciation, rent, and maintenance and utilities) directly attributable to fulfilling insurance contracts. Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics.
- **(m)** any other costs specifically chargeable to the policyholder under the terms of the contract

Initial recognition of transfers of insurance contracts and business combinations (paragraph 39)

Paragraph B93

When an entity acquires insurance contracts issued or reinsurance contracts held in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3, the entity shall apply paragraphs 14–24 to identify the groups of contracts acquired, as if it had entered into the contracts on the date of the transaction.

Paragraph B94

An entity shall use the consideration received or paid for the contracts as a proxy for the premiums received. The consideration received or paid for the contracts excludes the consideration received or paid for any other assets and liabilities acquired in the same transaction. In a business combination within the scope of IFRS 3, the consideration received or paid is the fair value of the contracts at that date. In determining that fair value, an entity shall not apply paragraph 47 of IFRS 13 (relating to demand features).

Paragraph B95

Unless the premium allocation approach for the liability for remaining coverage in paragraphs 55–59 applies and 69-70A applies, on initial recognition the contractual service margin is calculated applying paragraph 38 for acquired insurance contracts issued and paragraph 65 for acquired reinsurance contracts held using the consideration received or paid for the contracts as a proxy for the premiums received or paid at the date of initial recognition.

Paragraph B95A

If acquired insurance contracts issued are onerous, applying paragraph 47, the entity shall recognise the excess of the fulfilment cash flows over the consideration paid or received as part of goodwill or gain on a bargain purchase for contracts acquired in a business combination within the scope of IFRS 3 or as a loss in profit or loss for contracts acquired in a transfer. The entity shall establish a loss component of the liability for remaining coverage for that excess, and apply paragraphs 49–52 to allocate subsequent changes in fulfilment cash flows to that loss component.

Asset for insurance acquisition cash flows

Paragraph B95E

When an entity acquires insurance contracts issued in a transfer of insurance contracts that do not form a business or in a business combination within the scope of IFRS 3, the entity shall recognise an asset for insurance acquisition cash flows at fair value at the date of the transaction for the rights to obtain:

(a) future insurance contracts that are renewals of insurance contracts recognised at the date of the transaction; and

(b) future insurance contracts, other than those in (a), after the date of the transaction without paying again insurance acquisition cash flows the acquiree has already paid that are directly attributable to the related portfolio of insurance contracts.

Paragraph B95F

At the date of the transaction, the amount of any asset for insurance acquisition cash flows shall not be included in the measurement of the acquired group of insurance contracts applying paragraphs B93–B95A.