The Actuarial Society of Hong Kong

PURCHASE ACCOUNTING

2017 Insurance IFRS Seminar

Jeremy Menzies

Session 19

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香港精算學會

Purchase Accounting – General (IFRS 3)

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Purchase Accounting (“PA”)

- A “fresh start” - prior accounting becomes irrelevant
  - Existing reserves, DAC, etc., under IFRS 4 or US GAAP become irrelevant.
  - Under IFRS 17, existing CSM become irrelevant.
- All assets and liabilities are re-valued to fair value

PA Fundamental Principle

- The value of the acquired business on the books of the acquirer is the amount paid for it.
- The purchase price is a fair price, negotiated between the seller and buyer.
- The purchase is merely an exchange of assets of equal worth.
  - For the consideration paid (e.g. cash), the acquirer receives an asset or assets of equal value (e.g. all outstanding shares of the acquired company.)

IFRS 3-Acquisition Method

- Identify acquirer
- Determine acquisition date
- Recognize/measure assets acquired and liabilities assumed at fair value
- Recognize/measure goodwill or gain from bargain purchase

Some Intangibles to Consider

Type	Example
Customer-related	Customer Lists
Technology-based	Software licenses
Contract-based	Insurance contracts in force, but NOT insurance contracts expected to be written in the future. This does NOT meet the definition of an asset.

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Goodwill

- Let NAA = value of net assets acquired
  - Tangible and intangible assets less liabilities acquired measured at fair value
  - For purchase of an insurance company, fair value of insurance contracts is required (IFRS 13)
- Let PP = purchase price
- Goodwill = PP – NAA, an asset on the books of the acquirer. The total value of the acquired business is therefore NAA + GW = PP

Goodwill

- Goodwill is typically positive as part of the price may relate to future new business.
- If Goodwill is Negative (N/A under IFRS 17),
  - Review identification and valuation of assets acquired and liabilities assumed;
  - If still negative, taken as a gain in the income statement.

Portfolio Transfers (Assumption Reinsurance)

- The selling company transfers a portfolio of insurance contracts and the supporting assets.
- On the books of the acquirer, the fair value of the liabilities assumed is equal to the fair value of the assets transferred.
- There is no goodwill.

IFRS 17 application

Initial Measurement

- The purchase date is the date of initial recognition for acquired contracts i.e. a fresh start.
- The consideration received is a pre-coverage cash flow (initial premium).
- The consideration received is equal to
  - The cash received in a portfolio transfer
  - The fair value of the contracts in a business combination
    - Do not apply para 47 of IFRS 13 (relating to demand features)
- Groups of contracts are determined as of the transaction date (no need to determine retrospectively).

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Relationship to Fair Value

- Case 1: FV > Fulfillment Cash Flow
  - Then FCF – FV < 0 and CSM = FV – FCF
  - Total initial liability = FCF + CSM = FV
- Case 2: FV < Fulfillment Cash Flow
  - Then FCF – FV > 0 and CSM = 0
  - Total initial liability = FCF + CSM = FCF
  - Transfer: loss recorded of FCF-FV
  - Business combination: FV – FCF set equal to goodwill OR gain on a bargain purchase.
    - As FV-FCF is negative, it would be a reduction or offset to goodwill from other sources (say, other aspects of the acquisition). Goodwill cannot be negative.
- This is an exception to the general purchase accounting rules and requires IFRS 3 be amended (para 17, 20, 21 and 35 amended, para 31A and 64N created). Effective date same as IFRS 17.

Implications

- No more VOBA
- FV calculation
  - Insurance contracts are exempted from FV measurement
  - However, comparison to FV needed
  - Also needed for goodwill analysis
- Other intangible assets remain, e.g. bank assurance distribution rights

Thank You