

Chapter 11

Reporting Entity and Consolidation

Separate Statutory Funds

Principle 11.1

11.1 *The insurer, comprising both policyholder and shareholder¹ interests, is a single reporting entity which should prepare a single set of financial statements. In consequence:*

- (a) *the insurer's financial statements should include the assets, liabilities, income and expenses of any separate statutory funds associated with its insurance contracts; and*
- (b) *the effect of transactions between separate policyholder funds of an insurer should not be recognised in the financial statements as assets, liabilities, income or expenses. Income and expense from transactions between policyholder funds and shareholder funds should be eliminated. However, where such transactions affect the relative interests of policyholders and shareholders in the assets held in the respective funds, the effect of such transactions should not be eliminated in determining the balance sheet effect.*

11.2 Some jurisdictions require insurers, particularly life insurers, to place premiums received into separate funds, which as a priority must be used to pay claims. In many cases, shareholders can extract dividends from a fund only after certain solvency or capital adequacy levels within a fund have been established. In some jurisdictions, solvency or capital adequacy rules are coupled with a requirement that shareholders' funds are solely responsible for paying general creditors and such creditors have no recourse to the policyholders' funds. In some countries, different funds may exist for different groups of policyholders.

11.3 The requirements discussed in the previous paragraph may exist for performance-linked contracts, but may also exist for insurance contracts without performance linking.

11.4 Some argue that an insurer's financial statements should not include amounts relating to separate statutory funds, on one or more of the following grounds:

- (a) shareholders do not control the assets held in statutory funds because the shareholders have only restricted access to those assets. The insurer may be merely acting as an investment manager on behalf of the policyholders. Investment managers do not generally recognise assets under their management in their balance sheet as assets;
- (b) IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries*, requires that a subsidiary should be excluded from consolidation when

¹ References to shareholders are used for convenience and also encompass the members of a mutual insurer.

it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent. It could be argued that such restrictions apply in the case of some statutory funds; and

- (c) a net presentation is similar to the net presentation of pension plan assets under IAS 19, Employee Benefits.

11.5 This DSOP proposes that an insurer's financial statements should include amounts relating to separate statutory funds, because:

- (a) restrictions on the use of assets are not unique to insurance. The use of assets is restricted in many cases, for example, where a property is pledged as security for a loan. In such cases, the entity may be unable to sell the property, but can still obtain benefits from its continued use in the business. Similarly, shareholders may be required to give priority to the rights of policyholders in anything that they do with policyholder assets, but the assets are still employed in the insurance business to earn a return for the shareholders;
- (b) severe long-term restrictions of the type discussed in IAS 27 are rare. The most obvious example of such restrictions is where foreign exchange controls are introduced and severely restrict the repatriation of profits from a foreign subsidiary. Severe restrictions of this type are not ones that a profit-seeking parent would willingly take on. Thus, where insurers continue to enter and participate in an insurance market, restrictions imposed by regulators are unlikely to be as severe as those mentioned in IAS 27; and
- (c) general purpose financial statements are intended to meet the common information needs of a wide range of users. They are not intended to meet any more specific information needs of any particular groups of policyholders. General purpose financial statements may meet some of the needs of policyholders with interests in a specific statutory fund. If they need more detailed information about that statutory fund, their more specific needs could be met by special purpose reports about the status of the fund or about the status of their own interest in the fund. Such special purpose reports are beyond the scope of this project. Principle 14.XXX addresses the possible need for separate disclosures in general purpose financial statements about policyholder interests.

11.6 Some consider that the case for including separate statutory funds is not so strong where, as in some unitised funds, the policyholders have an undivided interest directly in the underlying assets rather than an interest in the fund. Some interests of this kind may not meet the definition of an insurance contract.

11.7 In consolidated financial statements, the reporting entity includes policyholder interests arising from insurance contracts issued by the parent or any of its subsidiaries.

Internal Transactions

11.8 Sometimes there are transactions between separate statutory funds and other parts of the reporting entity. An example helps to illustrate the issue. The assets relating to Fund A's policyholders include the building that accommodates all the insurer's administrative staff.

Fund A's policyholder funds were used to acquire the building and continue to be used to maintain the building. The administrative staff work on behalf of policyholders of Funds A, B and C. To be fair to the Fund A policyholders who own the building, a rent is charged to Funds B and C. The rent revenue of Fund A equals the rent expense of Fund B and Fund C, and the overall effect on net profit or loss for the period is nil. However, the absolute amounts of revenue and expenses may affect performance ratios, such as expense to premium ratios.

- 11.9 The question is whether these internal transactions should be eliminated, consistent with the requirement in IAS 27 to eliminate intra-group transactions. Some argue that elimination is inappropriate because it results in different reported revenue and expenses than those reported by an entity that rents its administrative building from another entity. Others argue that this argument is flawed because, if Funds A, B and C each owned a portion of the administrative building in proportion to the benefit that they derive from the building, no rent would be charged and the insurer would not be comparable with the entity that rents its building from another entity.
- 11.10 Some argue that internal transactions need not be eliminated if they were concluded according to normal market conditions, particularly if they have established policyholders' rights. Elimination would not be possible without reducing the policyholder liabilities, which would be misleading.
- 11.11 IAS 27 requires that intra-group balances and intra-group transactions and resulting unrealised profits should be eliminated in full in consolidated financial statements. Unrealised losses resulting from intra-group transactions should also be eliminated unless cost cannot be recovered. This DSOP proposes that similar eliminations should be made for transactions between different funds included in the financial statements of an insurer. Financial statements should not report internal transactions as if they were transactions with an external party. However, the balance sheet should reflect any impact of internal transactions on the respective interests of different stakeholders.
- 11.12 Transfers of cash and other assets between funds may include a withdrawal of capital from a policyholder fund to a shareholder fund or a transfer of additional capital from a shareholder fund to a policyholder fund. Because the insurer and any separate statutory funds form a single reporting entity, such transfers do not affect the financial statements.
- 11.13 Transfers of cash and other assets between funds may also include a transfer of profit from a policyholder fund to a shareholder fund. Principle 7.1 proposes that policyholders' effective interest in unallocated divisible surplus should be classified as a liability. Therefore, such transfers do not affect the financial statements directly, although they may affect the financial statements indirectly if the amount actually allocated differs from previous estimates.
- 11.14 Under IAS 14, Segment Reporting, segment revenue, segment expense, segment assets, and segment liabilities are determined after eliminating intra-segment balances and intra-segment transactions, but without eliminating intra-group balances and intra-group transactions between group entities in different reportable segments. In other words, if separate funds are in different reportable segments under IAS 14, transactions between those funds would be reflected in segment disclosures. In terms of the above example, Fund A's segment revenue includes rent revenue and the segment expense for Fund B and

C segments includes rent expense. Appendix 2 to IAS 14 contains a specimen disclosure that illustrates the presentation of segment disclosures before eliminations, with a final column to show the effect of eliminations.

Transferee Accounting for a Block of Insurance Contracts

Principle 11.2

11.15 An insurer should not recognise goodwill when it acquires a block of insurance contracts in a transaction that is not a business combination as defined in IAS 22, Business Combinations. The insurer should recognise any difference between the entity-specific value or fair value of the block of contracts at the transaction date and the amount paid as income or expense in the income statement.

11.16 Insurers sometimes buy and sell blocks of insurance contracts. For example, one insurer may wish to exit from the professional indemnity market and sell its existing contracts relating to that business to another insurer that is wishing to enter or expand in that market. The transfer of a block of insurance contracts differs from reinsurance if a transfer relieves the selling insurer of its obligation to the policyholders. This principle discusses how the transferee should account for such transfers. Principle 2.3 (derecognition) covers the accounting by the transferor.

11.17 The transfer of blocks of insurance contracts usually involves the transfer of any future premiums, insurance liabilities and assets supporting those contracts, including perhaps potential for future new or renewal business with the same customers. In some jurisdictions there are few obstacles to transfers of blocks of insurance contracts and they occur frequently. In other jurisdictions the regulatory environment may make the transfer of a block of business almost impossible. For example, there may be a requirement for 100% of policyholders to vote in favour of a transfer.

11.18 Transfers of blocks of insurance contracts raise a number of financial reporting issues. An example helps to illustrate these. Assume that an insurer buys a block of insurance in exchange for a cash receipt of 800. The buying insurer considers it has acquired a liability with an entity-specific value and fair value of 1,000² and 200 of value in the form of possible future new business and future investment margins on existing contracts.

11.19 One possible treatment is for the transferee to recognise the block of contracts as if they had always been part of its own business, which would give rise to the following accounting entries.

² For simplicity, this example assumes that the entity-specific value and fair value are the same in this case.

	Debit	Credit
Cash / Receivable from selling insurer	800	
Income statement (expense / loss)	200	
Insurance liability		1,000

Table 11.1 – Acquiring a Block of Insurance Contracts: Separate Acquisition

- 11.20 Another possible treatment is for the acquiring insurer to treat the acquisition of the block of contracts as if it had acquired another life insurer. Under IAS 22, *Business Combinations*, there could be the following accounting entries.

	Debit	Credit
Cash / Receivable from selling insurer	800	
Acquired goodwill (asset)	200	
Insurance liability		1,000

Table 11.2 – Acquiring a Block of Insurance Contracts: Business Combination

- 11.21 Some analyse the “acquired goodwill” shown in Table 11.2 as an intangible asset, rather than as goodwill. Under IAS 38, *Intangible Assets*, an intangible asset should be recognised if, and only if:
- (a) it is probable that the future economic benefits that are attributable to the asset will flow to the entity. An entity should assess the probability of future economic benefits using reasonable and supportable assumptions that represent management’s best estimate of the set of economic conditions that will exist over the useful life of the asset. An entity uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence; and
 - (b) the cost of the asset can be measured reliably. If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably, particularly when the purchase consideration is in the form of cash or other monetary assets.
- 11.22 Some argue that the same treatment should apply regardless of whether a block of insurance contracts or another insurer is acquired. They argue that it is difficult to make a clear distinction between a business combination and a transfer of a block of contracts, given that transactions span a wide spectrum from pure transfers of insurance liabilities to acquisitions of whole operations. In some jurisdictions, it may be possible to choose the form of the transaction, that is, a block of contracts may be sold as it is, or may be transferred into an entity and then sold. This may open the way for changing the accounting treatment based on the form of the acquisition.

11.23 For the following reasons, this DSOP proposes that an insurer should recognise any difference between the amount paid for a block of contracts and the entity-specific value or fair value of that block as income or expense in the income statement.

- (a) Goodwill arises only when operations are transferred and cannot arise in the acquisition of a block of insurance contracts. Because transfers of individual assets and liabilities do not involve the transfer of operations (which might require the transfer of, for example, a distribution system or employees), they differ from business combinations. IAS 22 defines a business combination as “the bringing together of separate enterprises into one economic entity as a result of one enterprise uniting with or obtaining control over the net assets and operations of another enterprise”.
- (b) Although the potential for future new or renewal business with the same customers is arguably an intangible asset, that asset is essentially a customer relationship. Paragraph 16 of IAS 38, *Intangible Assets*, explains that “the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets”. It follows that customer relationships and similar items will not normally qualify for recognition as an asset under IAS 38. There is no compelling reason to overturn this general principle in the specific case of the acquisition of customer relationships together with a block of insurance contracts.
- (c) The treatment proposed by principle 11.2 for the acquisition of a block of insurance contracts is consistent with the following proposals elsewhere in this DSOP for the acquisition of a single insurance contract: the insurer should recognise only its contractual rights and obligations (principle 2.2); and acquisition costs should be recognised as an expense (principle 4.11) when incurred.

Horizontal Groups

Principle 11.3

11.24 *The Standard should not prescribe whether a horizontal group that includes an insurer should prepare combined financial statements covering all the entities under unified management.*

11.25 Insurers (particularly mutual insurers) often form horizontal groups (groups of insurers under unified management but without a single controlling parent). As horizontal groups are more common in the insurance industry than in many other industries, the Issues Paper proposed that IASC should introduce a requirement for horizontal groups that include insurers to prepare combined financial statements covering all the entities under unified management. However, this DSOP does not address this issue, on the basis that it is a more general issue and should not be addressed in an industry-specific Standard.