

# Deferred Tax

## Basic issue 12      Should an Insurer Discount Deferred Tax Liabilities and Deferred Tax Assets Relating to Insurance Contracts?

653. Under IAS 12, Income Taxes, an enterprise determines deferred tax assets and liabilities by comparing the carrying amount of an asset or liability with its tax base. Table 14 illustrates this point.

An insurer has an insurance liability with a carrying amount of 100. The tax base of the liability is 140. The tax rate is 25%.

*The deferred tax liability is computed as follows:*

<i>Carrying amount</i>	<i>100</i>
<i>Tax base</i>	<i><u>140</u></i>
<i>Taxable temporary difference</i>	<i><u>40</u></i>
<i>Deferred tax liability (40@ 25%)</i>	<i><u><u>10</u></u></i>

**Table 14 – Deferred Tax**

654. The purpose of this computation is to determine (and recognise) the amount of tax that the enterprise would pay if it recovers the carrying amount of its assets and settles its liabilities for the carrying amount. Thus, the focus of this computation is on incremental future cash flows. This focus on future cash flows naturally raises the question of whether the computation should be on a present value basis. This question is particularly pertinent for enterprises that measure most of their assets and liabilities on a present value basis, for example at fair value reflecting current market prices or on the basis of an explicit discounting computation. Most life insurers measure their insurance liabilities on a present value basis. Some general insurers also measure their insurance liabilities on a present value basis, although this is less common than for life insurers.
655. For assets and liabilities that are measured on a present value basis, the deferred tax computation under IAS 12 is partly on a discounted basis (because the carrying amount is determined on a discounted basis) and partly on an undiscounted basis (because the tax base is often an undiscounted amount). Also, the tax cash flows may not occur at the same time as the underlying cash flows.
656. To eliminate this inconsistency, some argue that deferred tax should be measured on a present value basis if the deferred tax arises from liabilities that are measured on a present value basis. If this were done, the tax base would need to be determined on a discounted basis. It would also be necessary to consider what discount rate(s) should be used in the deferred tax computation.
657. Others argue that IASC should not introduce discounting of deferred tax assets and liabilities on a piecemeal basis only for insurance contracts. They believe that IASC

should consider in the recently approved project on discounting whether to require or permit discounting of all deferred tax assets and liabilities.

658. IAS 12 gives the following reasons for not requiring or permitting discounting of deferred tax assets and liabilities:
- (a) the reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each temporary difference. In many cases such scheduling is impracticable or highly complex. Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities; and
  - (b) to permit, but not to require, discounting would result in deferred tax assets and liabilities which would not be comparable between enterprises.
659. Those who support discounting of deferred tax for insurance policies argue that insurers are already used to scheduling future cash flows, so that it would not be impracticable to schedule the reversal of temporary differences.
660. In some countries, it is the practice to consider the effect of tax cash flows relating to policyholders and/or shareholders when measuring insurance liabilities.

*Tentative Steering Committee View*

661. *The Steering Committee recommends that IASC should consider in the project on discounting whether to require or permit discounting of all deferred tax assets and liabilities.*

# Reporting Enterprise and Consolidation

## Basic issue 13      What is the Reporting Enterprise for an Insurer?

662. This section discusses the following sub-issues:

- (a) does the reporting enterprise for an insurer include any separate statutory funds;
- (b) should the reporting enterprise include investments and liabilities relating to investment-linked contracts;
- (c) how should a parent treat its interest in an insurer subsidiary; and
- (d) should horizontal groups be required to present consolidated financial statements covering all enterprises under unified management?

### Sub-issue 13A      Does the Reporting Enterprise for an Insurer Include any Separate Statutory Funds?

663. Because it is critical that insurers have assets available to meet policyholders' claims, some jurisdictions require insurers to place premiums received into separate funds, which as a priority must be used to pay claims. In many cases, stockholders 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 stockholders' funds are solely responsible for paying general creditors and such creditors have no recourse to the policyholders' funds. The significance of having assets available to meet policyholder claims becomes greater as insurance contract periods lengthen, and the use of separate funds is probably more widespread for life insurers than for general insurers. In addition, the nature of life insurance as a source of funds for policyholders in time of personal crisis and as retirement savings has led many regulators to place a particular emphasis on protecting life insurance policyholder funds.
664. There may be a separation of policyholder interests from stockholder interests. There may also be a separation of one group of policyholder interests from another group of policyholder interests. This latter situation can arise where regulators wish to prevent cross-subsidisation of one group of policyholders to the detriment of another group of policyholders. This may arise where an insurer conducts both life and general insurance or where a life insurer conducts some business for which the policyholder bears the investment risk and other business for which the insurer bears some or all of the investment risk. Accordingly, the issue of separate funds can affect mutual insurers as well as stockholder-owned insurers.
665. The degree of separation between funds varies from one jurisdiction to the next. At one end of the spectrum, the use of funds within an insurer may simply be a bookkeeping device that facilitates their administration: such funds are actually

operated on an integrated basis with the governing body able to transfer assets between the funds without restriction and make operating and financing decisions on a group-wide basis. This is true, for example, in the United States, where a separation into funds of any economic significance generally occurs only for mutual insurers at the time of a demutualisation. At the other end of the spectrum, the separation between funds may be such that some argue that the funds are not part of the insurer and should not be included in its financial statements - in other words, they suggest that the insurer and the separate funds do not form a single reporting enterprise.

666. IASC's Framework for the Preparation and Presentation of Financial Statements describes a reporting enterprise as "an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise". It also notes that:

The Framework is concerned with general purpose financial statements ... including consolidated financial statements. Such financial statements are prepared and presented at least annually and are directed towards the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view.

Accordingly, the IASC's framework envisages one general purpose financial report catering to a variety of needs.

667. A survey conducted in Australia in 1989 among life insurers indicated that the users of life insurers' general purpose financial statements comprised a broad range of groups. The main focus was on stockholders and policyholders, both existing and potential, and their advisers. Other groups mentioned included government regulators of securities markets and of solvency, employees and sales representatives, creditors and media commentators. There was also an indication from most respondents that one set of financial statements should be able to accommodate most users' general needs. The more specific needs of policyholders would be met with individual reporting of the status of each insurance contract and the specific needs of regulators would be met with additional information about solvency and capital adequacy, although some of the needs of both policyholders and regulators would be met by general purposes financial statements.
668. IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries, sets out rules about the boundaries of a reporting enterprise that is a group of enterprises. Under IAS 27, an enterprise consolidates all enterprises that it controls. IAS 27 defines control as "the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities". Although IAS 27 addresses the relationship between a parent and its subsidiaries, the same principles may be appropriate in determining whether an insurer and any separate statutory funds form a single reporting enterprise.

669. 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) stockholders do not control the assets held in statutory funds because the stockholders have only restricted access to those assets. The insurer may be merely acting as an investment manager on behalf of the policyholders;
  - (b) IAS 27 requires that a subsidiary should be excluded from consolidation when 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) assets designated as relating to stockholders, which may be kept in a separate stockholder fund, are distinguishable from policyholder assets because the policyholders would not have access to those assets in the normal course of events.
670. Others argue that an insurer's financial statements should include amounts relating to separate statutory funds, on one or more of the following grounds:
- (a) restrictions on the use of assets are not unique to the insurance industry. 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, stockholders 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 stockholders;
  - (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) assets designated as relating to stockholders are likely to be kept within the insurer to satisfy solvency or capital adequacy regulations, and will be called upon to help pay policyholder claims in the event of severe adverse experience.
671. 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. Interests of this kind may not meet the definition of an insurance contract (see Sub-issue 1B).

*Tentative Steering Committee View*

672. *The Steering Committee considers that the insurer, comprising both policyholder and stockholder interests, is a single reporting enterprise which should prepare a single set of financial statements. Restrictions imposed by insurance regulators on the use of policyholder assets are not sufficient to justify excluding the assets and liabilities of different classes of policyholders and any stockholders.*
673. *Although policyholder interests and stockholder interests comprise a single reporting enterprise, there may be a need for separate disclosures about policyholder interests. Sub-issue 18D addresses that question.*

**Sub-issue 13B            Should the Reporting Enterprise include Investments and Liabilities Relating to Investment-linked Contracts?**

674. Restrictions on the use of policyholder funds may be coupled with product characteristics that support a case that stockholders do not control the policyholder funds. This is particularly the case for insurance products that have the features of an investment where the policyholder bears the risks of volatility in market prices and yields (**investment-linked contracts**).
675. Some enterprises are in the business of earning fees for managing the assets of other enterprises. It is common practice that investment management enterprises do not recognise the assets they manage in their own financial statements. For example, an enterprise that receives a commission for managing the operation of a building by collecting rents and attending to maintenance on behalf of the owner of the building would not be considered to control the building for financial reporting purposes. The same practice applies where an enterprise receives fees for managing investments on behalf of pensioners or other investors.
676. Typically, the investor bears the risks associated with the investments held in managed funds. For example, an investor in an investment fund may acquire units in the fund, which effectively gives the investor exposure to a proportion of the assets within the fund. This is often contrasted with an investor placing funds in a bank deposit, which is a loan to the bank, and is not a proportionate interest in the assets underlying the bank.
677. Managers of funds may also be considered to face some investment risk on the basis that their fees may be a percentage of funds managed or a percentage of periodic investment returns or because they risk losing clients if those clients experience poor investment returns. Whilst these risks derive from investment performance, they are more in the nature of business risks for managers and would not be the basis for assuming that managers control the funds they manage.
678. Insurers are sometimes considered to be engaging in two separate but related businesses:
- (a) bearing risks on behalf of policyholders; and

(b) investing or managing policyholder funds.

679. In some cases, the contracts sold by life insurers involve only a small risk element and are substantially the same as investment products sold by investment managers. In some cases, the only difference between an investment product sold by a life insurer and a product sold by an investment manager outside the life insurance industry is that the value of the life insurance investment contract is automatically paid to the beneficiaries on the death of the policyholder (rather than remaining payable to the deceased's estate on the fulfilment of additional conditions such as the further passage of time).
680. Many financial conglomerates are active in a number of sectors, such as insurance, banking and investment management. Under current practices in many countries, investment products that are described as insurance appear on balance sheet and very similar products that are not described as insurance may be excluded from the balance sheet.
681. Some argue that policyholder assets and liabilities should not be consolidated where they do not meet the definition of an insurance contract, that is, where they are effectively investment contracts. Others note that there is a broad spectrum of products from pure risk to pure investment products, and argue that it may be difficult to determine the basis for making a distinction. There is the possibility that products which have both risk and investment elements could be unbundled into their component parts for financial reporting purposes, as discussed in Sub-issue 1E. Where such unbundling is practicable, some argue that the portion that is an investment product should be excluded from the financial statements in the same way that financial institutions other than insurers generally exclude funds that they manage for third parties.
682. The European Union's Insurance Accounts Directive requires insurers to show separately those assets relating to investment-linked business, and a corresponding amount as a liability, on the basis that the stockholders do not directly bear any investment risk for these assets. This presentation is also favoured in the United States and Canada. It is often supported on the basis that it best reflects the nature of investment-linked business, which seems to fall somewhere between the two extremes of managed investment business and pure risk business.
683. In some cases, an insurer may take on some investment mismatch risk. That is, the insurance contract may specify that the policyholder is exposed to particular types of investments or a particular investment index, such as commercial property or a commercial property index, whereas the insurer actually invests in different assets, such as equity securities, or in property assets that do not match the index. In such cases, insurers are doing more than simply managing the policyholders' funds, they are dealing on their own account, in the same way that a bank is dealing on its own account when it invests the proceeds of deposits received.
684. Insurers may also offer products that provide for at least the return of premiums, or some other form of capital guarantee. The form of such guarantees vary widely and include the guaranteed return of 100% of capital invested, the guaranteed return of

100% of capital plus periodic additions of income to the guaranteed amount, and the guarantee of less than 100% of capital. In the case of guarantees of say 80% or 60% of capital, it could be that there is little likelihood of the guarantees being of value to the policyholder and that they have no economic significance. Where the capital guarantee has economic significance, the insurer is doing more than simply managing another's assets.

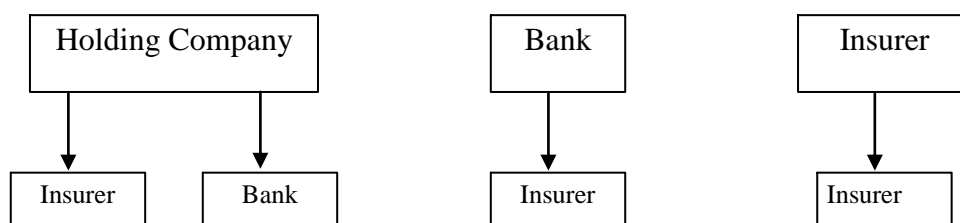
685. Capital guarantees are embedded derivatives. If insurance liabilities are not measured at fair value and if changes in their fair value are not recognised in the income statement, the capital guarantees may need to be accounted for separately (at fair value) under IAS 39, Financial Instruments: Recognition and Measurement (see Sub-issue 1E).

#### *Tentative Steering Committee View*

686. *The Steering Committee considers that liabilities under investment-linked insurance contracts, and the related investments, should be recognised in the balance sheet as two single line items (asset and liability). The Steering Committee notes that there is a strong argument for treating investment-linked contracts sold by insurers (life insurers in particular) in the same way that managers treat the funds they manage on behalf of investors, namely by not recognising assets and liabilities in relation to investment-linked contracts. However, the Steering Committee considers that the single line items treatment for investment-linked insurance contracts best reflects the terms of the contracts between insurers and policyholders. Sub-issue 18D addresses the question of separate disclosures about these items.*
687. *Where an insurance contract includes an investment-linked component, the contract may need to be unbundled so that the investment-linked component is treated in the same way as an investment-linked contract (see Sub-issue 1E).*

#### **Basic issue 13C      How should a Parent Treat its Interest in an Insurer Subsidiary?**

688. Insurers may be subsidiaries in a larger group of enterprises. For example, the following group structures are found in some jurisdictions.



**Figure 2 – Diversified Group Structure**

689. IAS 27 states that exclusion from consolidation on the basis that the activities of the parent and subsidiary are different is not justified “...because better information is provided by consolidating such subsidiaries and disclosing additional information in

the consolidated financial statements about the different business activities of subsidiaries”. Accordingly, some argue that the treatment adopted for an insurer subsidiary should be the same regardless of whether the parent is an insurer or a non-insurer.

690. Many of the matters considered above relating to sub-issue 13A are also relevant here. The key issue is whether a parent consolidates the whole insurer subsidiary, or only that part of the insurer that is directly attributable to stockholders.
691. Some argue that a parent should consolidate only that part of the insurer that is directly attributable to stockholders. They contend that the parent stockholder is interested only in this part of the insurer. They support this view with the arguments noted above for not combining stockholder and policyholder interests in the one reporting enterprise. They believe that the argument for this treatment is particularly strong for life insurance, where the assets required to support policyholder liabilities are often separately identified.
692. There are a number of possible methods of consolidating only that part of the insurer that is directly attributable to stockholders. One method is for the parent to recognise as an asset the parent’s portion of the equity of the life insurance business (including, perhaps, embedded value or **appraisal value**. See Sub-issue 11K for further discussion of embedded value), without recognising the underlying assets and liabilities of the insurer. In support of such methods, it can be argued that a parent’s interest in an insurer subsidiary is similar to an employer’s interest in a defined benefit pension plan. Under IAS 19, Employee Benefits, pension liabilities are measured as a net amount after deducting plan assets (if any) out of which the obligations are to be settled directly. The Basis for Conclusions published with IAS 19 states that this is because plan assets reduce (but do not extinguish) an enterprise’s own obligation and result in a single, net, liability. The presentation of that net liability as a single amount in the balance sheet differs conceptually from the offsetting of separate assets and liabilities. However, the Basis for Conclusions notes that the definition of plan assets in IAS 19 is consistent with the offsetting criteria in IAS 32, Financial Instruments: Disclosure and Presentation. IAS 32 requires offsetting of financial assets and financial liabilities when an enterprise:
- (a) has a legally enforceable right to set off the recognised amounts; and
  - (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.
693. Under IAS 19, an asset may arise where a defined benefit plan has been overfunded or in certain cases where actuarial gains are recognised. An enterprise recognises an asset in such cases because:
- (a) the enterprise controls a resource, which is the ability to use the surplus to generate future benefits;
  - (b) that control is a result of past events (contributions paid by the enterprise and service rendered by the employee); and

- (c) future economic benefits are available to the enterprise in the form of a reduction in future contributions or a cash refund, either directly to the enterprise or indirectly to another plan in deficit. The amount recognised as an asset under IAS 19 does not exceed the present value of those benefits (plus any unrecognised actuarial losses and past service cost).
694. For investment-linked insurance contracts, some argue for offsetting because the insurer manages the underlying assets on behalf of policyholders. On the other hand, the insurer does not normally transfer the underlying assets to the policyholder when the contract expires or is terminated; instead the insurer would normally have to sell the assets to repay the policyholder (unless new policyholders enter into new contracts at the same time). For other types of insurance contracts, it is clear that the set off criteria in IAS 32 would not generally be met, because there is no direct connection between the insurance liabilities and the assets held to meet them.
695. The other view is that a parent should consolidate the whole of the insurer. This view is supported by the same arguments used above to support the notion that the insurer reporting enterprise comprises both stockholder and policyholder interests. In line with the established practice in most industries, a parent should consolidate the whole of the entity it controls. In addition, normal consolidation principles require that all assets and liabilities (other than intra-group balances) recognised in individual financial statements should also be recognised in consolidated financial statements.

*Tentative Steering Committee View*

696. *The Steering Committee considers that a parent of an insurer subsidiary should consolidate the whole insurer subsidiary comprising the stockholder and policyholder interests that it controls.*

**Sub-issue 13D      Should Horizontal Groups be Required to Present Consolidated Financial Statements Covering all Enterprises under Unified Management?**

697. In many jurisdictions, life insurers are not allowed to carry on non-life insurance business and vice versa. In several jurisdictions, similar restrictions apply to health insurance. In order to provide a full range of insurance services, insurance companies usually form groups. Stockholder-owned insurers usually form “vertical” groups where one insurer controls other insurers or where a holding company controls a number of insurers.
698. It is more difficult for mutual insurers to form vertical groups as the owners of a mutual are its policyholders. In practice, mutuals form groups using one of two models:
- (a) a vertical group where the mutual controls one or more stock-holder-owned (i.e. non-mutual) insurer subsidiaries;

- (b) a “horizontal” group where two or more mutual insurers (or a mutual and a stockholder-owned insurer) are managed on a unified basis.
699. IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries, requires the parent of a vertical group to prepare consolidated financial statements. However, International Accounting Standards do not specify whether horizontal groups should prepare combined financial statements covering all the enterprises under unified management.
700. Some argue that IASC should address this issue (that is, combined financial statements for a horizontal group) as part of the insurance project because such arrangements are more common in the insurance industry than in other industries. Others argue that this is a more general issue and should not be addressed in a industry-specific Standard.

*Tentative Steering Committee View*

701. *In the Steering Committee’s view, horizontal groups should prepare combined financial statements covering all the enterprises under unified management.*
702. *The Steering Committee would welcome comments on any specific disclosures that may be needed to reflect the fact that the enterprises in a horizontal group may have different stakeholders.*

## **Basic Issue 14      How Should an Insurer Account for Subsidiaries, Associates and Interests in Joint Ventures?**

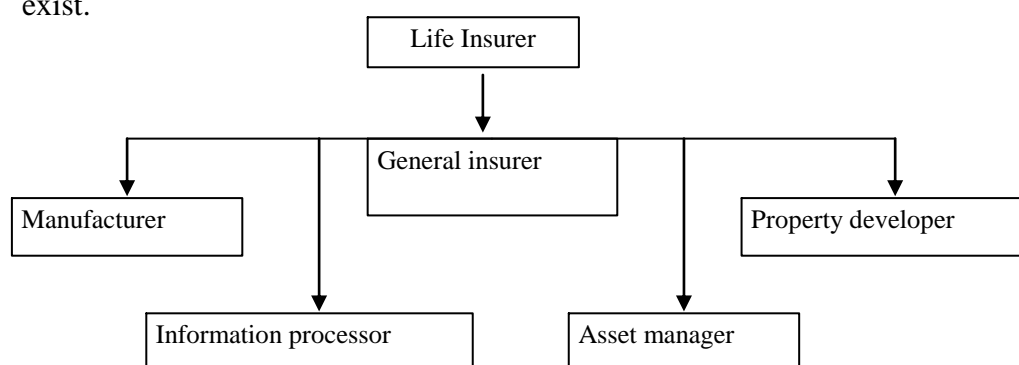
703. This section discusses the following Sub-issues:

- (a) should an insurer account for the excess of fair value over the net assets and liabilities of its subsidiaries; and
- (b) how should an insurer account for associates and interests in joint ventures?

### **Sub-issue 14A      Should an Insurer Account for the Excess of Fair Value over the Net Assets and Liabilities of its Subsidiaries?**

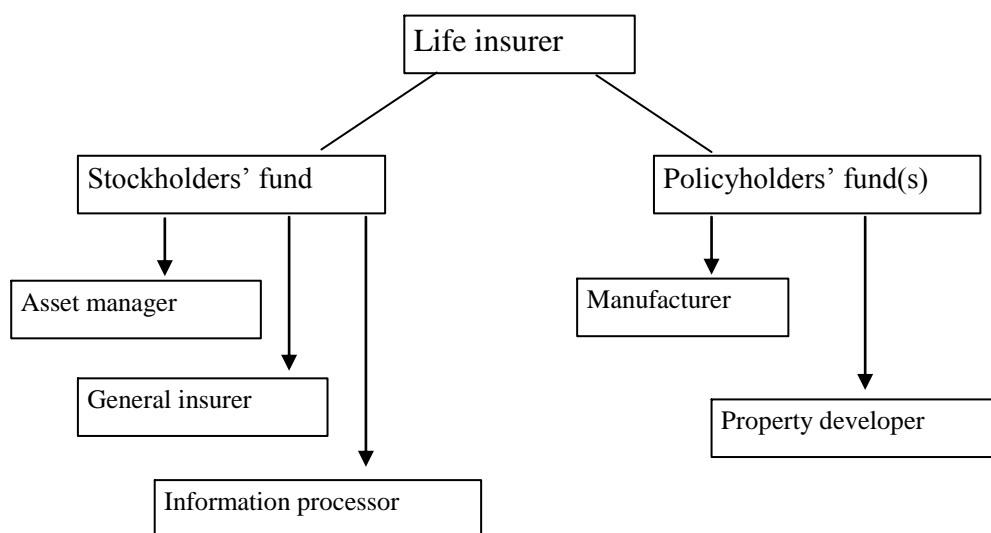
704. The fair value of an insurer's interest in a subsidiary may exceed the amount at which the subsidiary's assets less liabilities are included in the consolidated financial statements. This section considers how an insurer should account for that excess. It also discusses similar excesses that may arise for interests in associates and joint ventures.

705. An insurer's subsidiaries may conduct specific operations related to the insurance business such as information processing or may themselves be insurers. Alternatively, an insurer's subsidiaries may be held as investments and may have activities that are unrelated to the insurance business. For example, the following group structure may exist.



**Figure 3 – Non-insurance Subsidiaries**

706. As noted above, there may be a separation of policyholder interests from stockholder interests. A variation on the above example would be where the life insurer is structured in a way that places some of the subsidiaries under “policyholder interests” and others under “stockholder interests”. In some jurisdictions it may be normal to have the subsidiaries that conduct specific operations related to the insurance business under “stockholder interests” (which may have been set up with stockholders’ funds) and the subsidiaries that are more in the nature of investments under “policyholder interests” (which may have been acquired with policyholders’ funds). Figure 4 illustrates this structure.



**Figure 4 – Non-insurance Subsidiaries Held by Different Funds**

707. In other jurisdictions, the manner in which subsidiaries are held may be an accident of history or relate to tax laws or other regulations that provided an incentive for a particular group structure.
708. In the example shown in Figure 4, some would argue that the exact manner in which the subsidiaries are held should probably be irrelevant from the perspective of the life insurer parent. That is, it would seem appropriate for the same financial reporting result to be achieved regardless of the manner in which the subsidiaries are held.
709. In Figure 4, the location of the subsidiary that is an information processor could help characterise it as an operating subsidiary to be consolidated in the conventional way. This view may be well supported by the facts where, for example, the subsidiary does all of its work for the insurer or other members within the group. However, the information processing subsidiary may do some work for other enterprises, that is, the subsidiary is a business in its own right, and could be characterised as an investment and, perhaps, be measured at fair value.

*Alternatives for Dealing with Fair Valued Subsidiaries on Consolidation*

710. If a fair value basis is used to measure investments in subsidiaries in the parent's individual financial statements, there are two treatments that could be adopted on consolidation. The excess of the fair value over the net of the assets and liabilities of the subsidiary could be either:
- (a) recognised as a separate asset in the consolidated balance sheet; or
  - (b) excluded from the consolidated balance sheet.
711. Some argue that treatment (a) is needed where fair value accounting is used, because treatment (a) reflects fair value information about subsidiaries in the consolidated

financial statements, which are often the main focus for users. If fair value accounting is considered to be appropriate for an insurer's investments, treatment (a) treats all investments the same way regardless of whether they are subsidiaries.

712. Supporters of treatment (a) acknowledge that it leads to the recognition of internally-generated goodwill, which is not generally considered acceptable in a financial reporting model based on historical costs. However, they reason that the recognition of internally-generated goodwill of subsidiaries could be viewed as a necessary consequence of adopting a fair value model in consolidated financial statements.
713. Those who support treatment (b) argue that:
- (a) it is consistent with IAS 38, Intangible Assets, which specifically prohibits the recognition of internally-generated goodwill, because internally-generated goodwill is not an identifiable resource controlled by the enterprise that can be measured reliably at cost. The fair value over and above the amounts attributed in the consolidated financial statements to the subsidiary's net assets could arise partly because the subsidiary's assets are being carried at below fair value and partly because internally-generated goodwill has arisen since the parent acquired the subsidiary;
  - (b) treatment (a) would mean that an enterprise, in effect, recognises internally-generated goodwill for activities that happen to be carried out by a subsidiary and does not recognise internally-generated goodwill for activities that happen to be carried out by the parent itself. There is no precedent for a distinction of this kind, which is contrary to the statement in IAS 27 that "consolidated financial statements are the financial statements of a group presented as those of a single enterprise". In other words, consolidation ignores legal barriers between the individual enterprises included in the consolidation; and
  - (c) this is a more general issue and should not be addressed in an industry-specific Standard.
714. Some may argue that the choice between treatments (a) and (b) could depend on whether the investment subsidiaries are held by the policyholder funds or the stockholder fund. They would view the use of fair values for investments (treatment (a)) as more important in the context of the policyholder funds because such funds are more often characterised as investment vehicles. Also, they believe that treatment (a) may avoid measurement mismatches that could arise where insurance liabilities are measured at fair value and the assets held by policyholders' funds are not measured at fair value.
715. In some cases, the benefits paid to policyholders are linked directly to the fair value of a subsidiary (for example, in some cases, a subsidiary held by a separate statutory fund). To avoid a mismatch, some argue that the insurer's consolidated balance sheet should include the goodwill of the subsidiary at fair value in such cases, even if the general rule is to exclude such goodwill.

*Tentative Steering Committee View*

716. *The Steering Committee favours the following approach:*

- (a) *to the extent that policyholder benefits are linked directly to the fair value of a subsidiary, the consolidated balance sheet should include the goodwill of that subsidiary at its fair value (in other words the fair value of the investment in the subsidiary less its net assets). This goodwill should be disclosed separately because other goodwill is not measured at fair value – other acquired goodwill is measured at amortised cost and other internally generated goodwill is not recognised at all; and*
- (b) *in all other cases, the consolidated balance sheet should exclude the excess of fair value over the net assets (including unamortised purchased goodwill) less liabilities of subsidiaries, as this exclusion is consistent with accounting by other types of enterprises.*

717. *Based on the Steering Committee's tentative view on issue 13A, that the insurer reporting enterprise comprises both policyholder and stockholder interests, no distinction should be made based on whether the subsidiary is held via policyholder funds or via a stockholder fund.*

**Sub-issue 14B                      How should an Insurer Account for Associates and Interests in Joint Ventures?**

718. IAS 28, Accounting for Interests in Associates, requires the investor to recognise an associate initially at cost in its consolidated financial statements and then increase or decrease the carrying amount to recognise the investor's share of the profits or losses after acquisition. The investor's share of profits or losses is also reflected in the investor's consolidated income statement. This is known as equity accounting. In its own financial statements, the investor should either use equity accounting or account for associates at cost.

719. IAS 31, Financial Reporting of Interests in Joint Ventures, distinguishes three types of joint ventures:

- (a) for jointly controlled operations, IAS 31 requires joint venturers to recognise, in both their own financial statements and any consolidated financial statements: the assets that they control; the liabilities that they incur and expenses that they incur; and their share of the income that they earn from the sale of goods or services by the joint venture;
- (b) for jointly controlled assets, IAS 31 requires joint venturers to recognise: their share of the jointly controlled assets, classified according to the nature of the assets; any liabilities which they have incurred; their share of any liabilities incurred jointly with the other venturers in relation to the joint venture; any income from the sale or use of their share of the output of the joint venture, together with their share of any expenses incurred by the joint venture; and any

expenses which they have incurred in respect of their interest in the joint venture; and

- (c) for jointly controlled entities, IAS 31 requires joint venturers to use proportionate consolidation (benchmark) or equity accounting (allowed alternative).

720. When the Joint Working Group completes its work on financial instruments, the IASC Board may decide to amend IAS 28 and IAS 31. For example, insurers could be required to measure investments in associates or joint ventures at fair value. Where there is a difference between an investment's fair value and its carrying amount using equity accounting or proportionate consolidation, the issues discussed above in relation to subsidiaries will also be relevant. However, there may be cases where the carrying amount of an associate under equity accounting is a reasonable approximation to fair value. The use of such an amount may be particularly useful where there is not an active market for the investment and a fair value is not readily determinable.
721. The G4+1 group of accounting standard setters has recently published a position paper, *Reporting Interests in Joint Ventures and Similar Arrangements*. IASC may consider starting a project to amend IAS 28 and IAS 31 in the light of that group's work.

*Tentative Steering Committee View*

722. *As for investments in subsidiaries, the Steering Committee favours the following approach for investments in associates:*
- (a) *to the extent that policyholder benefits are linked directly to the fair value of an associate, the consolidated balance sheet should include that associate at its fair value; and*
  - (b) *in all other cases, the consolidated balance sheet should exclude the excess of fair value over the net assets (including unamortised purchased goodwill) less liabilities of associates, as this exclusion is consistent with accounting by other types of enterprises.*

**Basic Issue 15      How should the Transferee Account for the Transfer of a Block of Insurance Contracts?**

723. 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. This section discusses how the transferee should account for such transfers. Sub-issue 10E discusses the accounting by the transferor.
724. The transfer of blocks of insurance contracts usually involves the transfer of any future premiums, insurance liabilities and assets supporting those contracts, including perhaps an expectation of future profits on those contracts and potential for future new

or renewal business with the same customers. Because such transfers 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, Business Combinations, 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”.

725. 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 be such that the transfer of a block of business is almost impossible. For example, there may be a requirement for 100% of policyholders to vote in favour of a transfer.
726. The transfer of a block of insurance contracts differs from reinsurance because the selling insurer is being relieved of its obligation to the policyholders in one way or another. Transfers may be completed in a number of ways in relation to claims arising from events that occurred before the transfer. For example:
- (a) the transferee may take responsibility for all claims from the block of contracts that have not yet been paid. In this case, the transferor would account for the transaction as a sale and eliminate all the assets and liabilities associated with the transferred contracts. The transferee would need to recognise all the liabilities and any assets, such as salvage, associated with the transferred contracts. This form of transfer would normally apply to life insurance and other long-term business; or
  - (b) the transferee may take responsibility only for those claims from the block of contracts that arise from events occurring after the transfer. In this case, the transferor would continue to recognise liabilities and associated assets for events that give rise to claims before the transfer. The transferee would recognise liabilities and associated assets for claims arising from events after the transfer.
727. Transfers of blocks of insurance contracts raise a number of financial reporting issues. An example helps to illustrate these. Assume the following:
- (a) a life insurer sells a block of contracts to another life insurer;
  - (b) the net insurance liability transferred, as previously measured by the selling insurer is 1,000 and the buying insurer also considers 1,000 to be the appropriate amount at which to measure the insurance liabilities acquired as part of its ongoing business;
  - (c) the selling insurer pays the buying insurer 800 to take over the contracts and recognises a gain of 200; and
  - (d) the buying insurer considers it has acquired a 1,000 liability, 100 of profits embedded in the block of contracts and a further 100 of value in the form of possible future new business.

728. 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.

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

**Table 15 – Acquiring a Block of Insurance Contracts: Separate Acquisition**

729. 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. The treatment would then depend on how acquisitions of life insurer subsidiaries are treated. If they are treated in accordance with IAS 22, Business Combinations, there could be the following accounting entries.

	Debit	Credit
Cash / Receivable from selling insurer	800	
Embedded profits (asset)	100	
Acquired goodwill (asset)	100	
Insurance liability		1,000

**Table 16 – Acquiring a Block of Insurance Contracts: Business Combination**

730. The treatment in the United States and the United Kingdom is to recognise two separate assets (embedded profits of 100 and acquired goodwill of 100 in the example) and amortise them over the life of the contracts acquired. It seems logical to amortise the embedded profits over the life of the contracts acquired. However, as the acquired goodwill does not relate to those contracts, some argue that it is illogical to amortise the goodwill over that period. In Germany, the treatment is to recognise a single asset (200) and to amortise it over the economic duration of the portfolio, which is not necessarily the legal life.
731. Some might analyse the “acquired goodwill” shown in Table 16 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 enterprise. An enterprise 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 enterprise 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.
732. Some commentators argue that the same treatment should apply regardless of whether a block of insurance contracts or another insurer enterprise is acquired, because it would be artificial to make a distinction. In some jurisdictions it may be possible to choose the form of the transaction, that is, a block of contracts may be sold as they are 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. One solution would be to make a clear distinction between a business combination and a transfer of a block of contracts. The difficulty is that such a distinction may be difficult to make given that there will be transactions that span a wide spectrum from pure transfers of insurance liabilities to acquisitions of whole operations and anything in between.
733. The alternative view is that the acquisition of a block of insurance contracts does not give rise to recognisable goodwill because goodwill arises only when an operation is transferred and cannot arise in a transfer of individual assets and liabilities. Furthermore, the association with the entity originally writing the business may have been lost or it may be difficult to measure the purchased goodwill reliably after the date of acquisition. This latter point is important in practice because it may be virtually impossible to keep track of the purchased goodwill in future periods, particularly where the acquired contracts are of the same type as other contracts sold by the insurer and where the acquired and pre-existing contracts are managed together.
734. If the insurance liabilities of an acquired subsidiary are measured at fair value on acquisition (as required by IAS 22, Business Combinations), some would argue that the fair value already incorporates the embedded value element (see Sub-issue 11K for further discussion) and, perhaps, also the "acquired goodwill" element. Under that view, fair value measurement of insurance liabilities would eliminate the need to consider this sub-issue.
735. Some would argue that the transferee should not recognise the insurance liabilities acquired initially at fair value, unless fair value is also used for subsequent measurement. In particular, they suggest that the insurance liabilities acquired should be discounted only if other insurance liabilities are discounted. However, others would argue that the fair value at the date of acquisition establishes the cost basis for the liability and is therefore appropriate even if subsequent measurement is on a cost basis.

736. *The Steering Committee considers that the acquisition of a block of insurance contracts should be treated in the same manner as the acquisition of an insurance enterprise to avoid having similar transactions being treated differently.*

## **Basic Issue 16      Should the Effects of Internal Transactions be Eliminated from Financial Statements**

737. IAS 27, Consolidated Financial Statements and Investments in Subsidiaries 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 section discusses whether similar eliminations should be made for transactions between different funds included in the financial statements of an insurer.
738. As discussed above in Sub-issue 13A, within an insurer, or a group that includes an insurer, there could be a separation of the interests of the different stakeholders. These might include the separation of stockholder and policyholder interests or the separation of the interests of different groups of policyholders. Sometimes there are transactions between these different groups. In some jurisdictions, regulators require the effects of these transactions to be recorded to help ensure that each group is treated equitably and thereby preserve the relative interests of each group.
739. 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 Fund B and Fund C.
740. In this example, the rent revenue of Fund A would equal the rent expense of Fund B and Fund C, and regardless of whether they are eliminated, the overall effect on net profit or loss for the period will be the same. However, if the revenue and expenses are not eliminated, the absolute amounts of revenue and expenses will be greater. The absolute amounts of revenue and expenses may affect key performance ratios by which insurers are sometimes judged, such as expense to premium ratios.
741. Illustration A72 in the accompanying booklet considers the accounting entries required for rent paid by the stockholders' fund to the policyholders' fund for the use of a building owned by the policyholders' fund.
742. Some argue that it is inappropriate to eliminate the internal rent revenue and expenses as elimination results in different reported revenue and expenses than those reported by an enterprise that rents its administrative building from another enterprise. 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 enterprise that rents its building from another enterprise.

743. The common view in the context of most industries is that the insurer has not entered into a transaction with an external enterprise and the rent revenue and expenses should be eliminated. That is, from the perspective of the insurer as a reporting enterprise, there is no transaction or other event that gives rise to revenue or an expense. This treatment is consistent with the requirement in IAS 27 to eliminate intra-group transactions.
744. Some argue that internal transactions between policyholders' funds and stockholders' funds should not be eliminated. For example, a property may be owned by the life fund but occupied by the company's general insurance division which is owned by the stockholders. The policyholders will have received rentals during the year from the general insurance fund. These funds belong to the policyholders and therefore the policyholder liabilities will be increased as a result. Those who oppose elimination argue that elimination would not be possible without reducing the policyholder liabilities, which would be misleading.
745. The European Union's Insurance Accounts Directive states that internal transactions need not be eliminated if they were concluded according to normal market conditions and have established policyholders rights. The effect must be disclosed where material.
746. Another example of internal transactions that may need to be eliminated in preparing external financial statements is an insurance or reinsurance transaction between consolidated subsidiaries.
747. Transfers of cash and other assets between funds may include a withdrawal of capital from a policyholder fund to a stockholder fund or a transfer of additional capital from a stockholder fund to a policyholder fund. In Sub-issue 13A, the Steering Committee took the view that the insurer and any separate statutory funds form a single reporting enterprise. Therefore, such transfers do not affect the financial statements.
748. Transfers of cash and other assets between funds may also include a transfer of profit from a policyholder fund to a stockholder fund. In Sub-issue 9A, the Steering Committee concluded tentatively that unallocated divisible surplus should be classified as a liability, except to the extent that the insurer has no legal or constructive obligation at the balance sheet date to allocate part of the surplus to current or future policyholders (or has such a legal or constructive obligation, but cannot measure that obligation reliably). 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.
749. 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 enterprises 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.

*Tentative Steering Committee View*

750. *The Steering Committee considers that 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 stockholder funds should be eliminated. However, where such transactions affect the relative interests of policyholders and stockholders in the assets held in the respective funds, the effect of such transactions should not be eliminated in determining the balance sheet effect.*
751. *The Steering Committee notes, however, that the effects of transactions between separately reported segments need to be preserved in segment disclosures. Appendix 2 to IAS 14, Segment Reporting, contains a specimen disclosure that illustrates the presentation of segment disclosures before eliminations, with a final column to show the effect of eliminations.*

# Interim Financial Reporting

## **Basic Issue 17      Is More Guidance Needed to Supplement IAS 34 on the Treatment of Insurance Contracts in Interim Financial Reports?**

752. IAS 34, Interim Financial Reporting, requires that:
- (a) an enterprise should apply the same accounting policies in its interim financial statements as in its annual financial statements, except for accounting policy changes that are to be reflected in the next annual financial statements. However, the frequency of an enterprise's reporting (annual, half-yearly, or quarterly) should not affect the measurement of its annual results. To achieve that objective, measurements for interim reporting purposes should be made on a year-to-date basis; and
  - (b) costs that are incurred unevenly during an enterprise's financial year should be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.
753. Appendix 2 to IAS 34 gives examples of applying these principles.
754. Certain insurers currently estimate the full year result and allocate part of the result to the interim period. However, where results are estimated for the year, compliance with IAS 34 will require that specific events arising are allocated to the interim period in which they occur. For example, if a major catastrophe occurs in the first quarter, this loss should be allocated in full in that period. Some believe that this point may need to be emphasised in the insurance standard to ensure the correct application of IAS 34 and to ensure consistent treatment between insurance enterprises.
755. IAS 34 recognises that interim measurements may rely on estimates to a greater extent than measurements of annual financial data. Appendix 3 to IAS 34 gives some examples of the use of estimates for interim measurements.
756. Some believe that additional guidance would be helpful to explain how IAS 34 applies to insurance contracts. Others believe that the general guidance in IAS 34 is sufficient.

### *Tentative Steering Committee View*

757. The Steering Committee does not intend to develop guidance on the application of IAS 34 to insurance contracts. If commentators believe that such guidance would be helpful, the Steering Committee would appreciate comments on the form that such guidance should take.