

IFRS Developments for Insurers

IFRS 10 Consolidated Financial Statements - an insurer's perspective

A single control model that may impact what an insurer consolidates from 1 January 2013

What you need to know

- ▶ IFRS 10 includes a new definition of control, which may affect insurers with interests in funds, structured entities, unit linked assets and liabilities or control of specified assets.
- ▶ IFRS 12 includes all of the disclosure requirements for group and structured entities.
- ▶ Significantly more judgement is required to apply IFRS 10.
- ▶ Insurers with interests in funds will be required to re-perform their assessment of whether a fund should be consolidated. This could be a time-consuming exercise and gathering the data to support this type of assessment may be challenging.
- ▶ IFRS 10 and IFRS 12 are effective for annual periods beginning on or after 1 January 2013.

In May 2011, the International Accounting Standards Board (the IASB) issued IFRS 10 *Consolidated Financial Statements*, which becomes effective for annual periods beginning on or after 1 January 2013. IFRS 10 must be applied retrospectively.

IFRS 10 establishes a single control model that applies to all entities, including 'special purpose entities'. SIC-12 *Consolidation-Special Purpose Entities* has been withdrawn. The portion of IAS 27 *Consolidated and Separate Financial Statements* that addresses the accounting for consolidated financial statements has been moved from IAS 27 to IFRS 10; it has not changed. What remains in IAS 27 is limited to accounting for investments in subsidiaries, joint ventures and associates in separate financial statements.

The changes introduced by IFRS 10 will require management to exercise significant judgement to determine which entities are controlled, and therefore are required to be consolidated by a parent, compared with the requirements that were in IAS 27. Therefore, IFRS 10 may change which entities are included within a group.

New definition of control

An investor consolidates an investee when it controls the investee. The investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. This principle applies to all investees, including structured entities.

An investor must possess all of the following elements to be deemed to control an investee:

- ▶ Power over the investee, which is described as having existing rights that give the current ability to direct the activities of the investee that significantly affect the investee's returns (such activities are referred to as the 'relevant activities')
- ▶ Exposure, or rights, to variable returns from its involvement with the investee

And

- ▶ Ability to exert power over the investee to affect the amount of the investor's returns

The main change introduced by IFRS 10 compared with the existing consolidation requirements is a greater focus on which investor has power over an investee's activities rather than who has the majority of the voting rights. Significant judgement may be required to determine whether an investor has control. While the consolidation assessment may not change for many entities, the effect will depend on the specific terms of each structure.

Disclosures under IFRS 12

IFRS 12 *Disclosure of Interests in Other Entities* combines the disclosure requirements for an entity's interests in subsidiaries, joint arrangements, associates and structured entities into one comprehensive disclosure standard. The objective of IFRS 12 is for an entity to disclose information that helps users of its financial statements evaluate:

- ▶ The nature of, and risks associated with, its interests in other entities
- ▶ The effects of those interests on its financial position, financial performance and cash flows

IFRS 12 requires disclosure of the significant judgements and assumptions used in determining which entities an insurer controls and consolidates.

IFRS 10 for insurers

In this publication, we explore some of the key issues for insurers under IFRS 10.¹

¹ Refer to IFRS Developments – IASB issues three new standards: Consolidated Financial Statements, Joint Arrangements, and Disclosure of Interests Other Entities, Issue 1 (IFRS Developments, Issue 1) and Applying IFRS: IFRS 10 Consolidated Financial Statements – Challenges in Adopting and Applying the New Standard (September 2011) for more complete summaries and analyses of IFRS 10 and 12. These publications are available at www.ey.com/IFRS.

Interests in funds

An insurer's investment portfolio normally includes several different asset classes, such as a mixture of directly held investments (i.e., equities or debt instruments) and indirectly held investments (i.e., investment in funds).

It is not unusual for an insurer to act as a fund manager and be responsible for the day-to-day investing activities of a fund. If a fund is not consolidated, the insurer will typically measure its investment in the fund as the product of the number of units held multiplied by the unit price.² What insurers need to consider under IFRS 10 is whether funds that are not consolidated under IAS 27 will remain unconsolidated under IFRS 10, as well as whether those funds that were consolidated in the past will qualify for consolidation under IFRS 10.

When evaluating if a fund should be consolidated, there are two fundamental considerations that insurers need to consider:

a) Whether it has control over the fund

And

b) Whether it is acting in the capacity of principal or agent

Control assessment

Insurers should consider a number of factors when assessing whether they have control over an investment fund, such as:

- ▶ Whether the insurer has power over the investment fund. IFRS 10 states that power arises from rights, such as voting rights, potential voting rights (e.g., options) and contractual rights to appoint key personnel (e.g., the fund manager). When considering voting rights, insurers need to consider whether the rights are substantive. To be substantive, rights needs to be exercisable.

² Assuming that the insurer does not have significant influence over the investee, in which case it may account for the investment as an associate using the equity method, in accordance with IAS 28 *Investments in Associates and Joint Ventures*

- ▶ The insurer also has to consider whether it has *de facto* control of the investment fund. Applying the concept of *de facto* control is likely to be a major change in practice for insurers that have significant, but not majority (i.e., less than 50%) equity interests in investment funds, and may result in these investment funds being consolidated. For example, an insurer will need to assess its own voting rights, relative to the size and dispersion of holdings of the other vote holders.

Principal /agent analysis

If the insurer acts as the fund manager, it needs to assess whether it is acting as principal or agent, when decision-making rights have been delegated to the insurer as fund manager. Insurers will need to consider all facts and circumstances in making this assessment, for example:

- ▶ What range of activities can the insurer direct in its capacity as fund manager, and what level of discretion does it have in making decisions about those activities?
- ▶ What rights are held by others (e.g., 'kick-out rights'), and whether those rights are held by a single party, or require the agreement of many parties to kick out the insurer from its role as fund manager?
- ▶ Is the asset management fee that is paid to the fund manager commensurate with the activities performed? Is the magnitude and variability of the fee in comparison to the variability of the fund's return such that the insurer as fund manager is a principal?
- ▶ What other interests are held by the insurer (or other entities in its consolidated group), and is the magnitude and variability of those interests in comparison to the variability of the fund's return such that the insurer as fund manager is a principal?
- ▶ Whether any other parties are acting on the insurer's behalf without a contractual agreement, such that the insurer has the

ability to direct that party to act on its own behalf (*de facto* agents)?

Control of specified assets (silos)

IFRS 10 provides application guidance around whether an investor may have control over a silo. A silo is part of an entity, for which control is assessed as if it were a separate entity, when all of the following criteria are met:

- ▶ Specified assets of the entity are the only source of payment for specified liabilities of (or other interests in) the entity.
- ▶ Apart from the party with the specified liability of the silo, other parties do not have rights or obligations related to the specified assets or to residual cash flows from the assets.

Thus, effectively, the assets and liabilities are ring-fenced. For insurers, this situation may arise in a structure such as a multi-cell reinsurance vehicle, which is an entity comprised of a number of 'cells' where the assets and liabilities of each cell are ring-fenced.

Insurers will have to evaluate whether investments made on behalf of policyholders would be considered silos under IFRS 10, and if so, whether the insurer controls that silo. If it does, consolidation is required at the silo level and not at the entity level.

In considering whether a silo exists, insurers will need to assess all the facts and circumstances in the arrangement, including local statutes in the particular jurisdiction. For example, the following should be considered when evaluating whether a silo exists:

- ▶ Do the policyholders select the investments?
- ▶ Will other funds beyond the value of the specified assets in the silo be necessary to fulfil the obligation to the policyholders?
- ▶ Is there an exact matching of the policy to the assets held?

Unit-linked assets and liabilities

Many insurers issue unit-linked insurance and investment contracts to policyholders under terms that vary depending on the nature of the coverage, benefits offered and the jurisdictions in which they are issued.

Typically under these unit-linked policies, an insurer promises to make payments to policyholders that are based on the performance of a specified pool of assets (or indices) and the insurer purchases assets to match these linked liabilities. Linked liabilities are generally measured as the product of the number of units issued to policyholders and the relevant fund unit price.

A similar measure is used for an insurer's investment in the fund. The result is a matching of assets and liabilities on the insurer's balance sheet, with the value of unit-linked assets normally equalling the value of the liability to unit-linked policyholders.

An insurer will need to assess whether it is considered to be the principal or the agent in this arrangement, and whether silos of specified assets exist. This will drive the conclusion of whether investment funds in unit-linked assets are consolidated under IFRS 10. Examples of factors that the insurer needs to consider in performing this assessment are:

- ▶ Whether assets backing unit-linked liabilities are separate from other assets held. For example, in the case of liquidation, are these assets ring-fenced such that they can only be used to settle the liabilities of the unit-linked policyholders? If this is not the case, insurers may experience some difficulty in demonstrating that these assets are being held strictly for the benefit of the unit-linked policyholders and not for the benefit of the insurer's shareholders.
- ▶ Whether there is any obligation for the insurance company to invest in the assets backing these unit-linked liabilities, and

therefore, whether the decision to invest in these assets really lies with the insurer and not with the policyholders.

After considering the issues noted above, insurers may have to consolidate the investment funds that back the liabilities of unit-linked policyholders. There may also be situations where an insurer already consolidates investment funds backing unit-linked liabilities, a decision that is driven by the size of its investment in the fund and insurers will need to re-assess whether or not the fund should continue to be consolidated under the single control model in IFRS 10. Either way, changes in whether funds are consolidated may have a significant impact on the insurer's balance sheet. Management may wish to focus its attention on this issue early enough to help avoid surprises upon the adoption of IFRS 10.

Investment in structured entities

IFRS 12 defines a structured entity as "an entity that has been designed so that voting rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements."

A structured entity often has restricted activities, a narrow or well-defined objective, very little equity and is financed by multiple contractually linked instruments.

It is not unusual for insurers to create structured entities to facilitate specialised transactions, (e.g., the reinsurance of risks into a special purpose vehicle). In these circumstances, the insurer may have consolidated these entities based on the risk and reward model under SIC-12. Under IFRS 10, insurers will consider whether they have control over these entities, paying special attention to those entities that operate under an 'auto-pilot' mechanism.

Insurers may find it challenging to determine what the relevant activities for these structured entities are and who directs these relevant activities. This assessment may produce different results from those under SIC-12.

What does IFRS 10 mean for insurers?

The following diagram is a typical example of a roadmap that an insurer may follow when assessing whether an investee should be consolidated or not.

Planning for the effective date

Applying IFRS 10 will require significant time and effort. Insurers should plan accordingly and begin the process early, considering the items below:

- 1) Early assessment of the impact of IFRS 10 enables insurers to make strategic decisions about the structure of the group, taking account of the tax and regulatory implications. Insurers have a limited opportunity to ensure that new contracts entered into are in line with the group's overall strategy. Insurers will have the opportunity to consider existing arrangements to determine whether potential changes are required.
- 2) New processes and systems (or modifications to existing processes and systems) may be needed to gather information (such as contract agreements and other data related to investments). This information is necessary to assess the

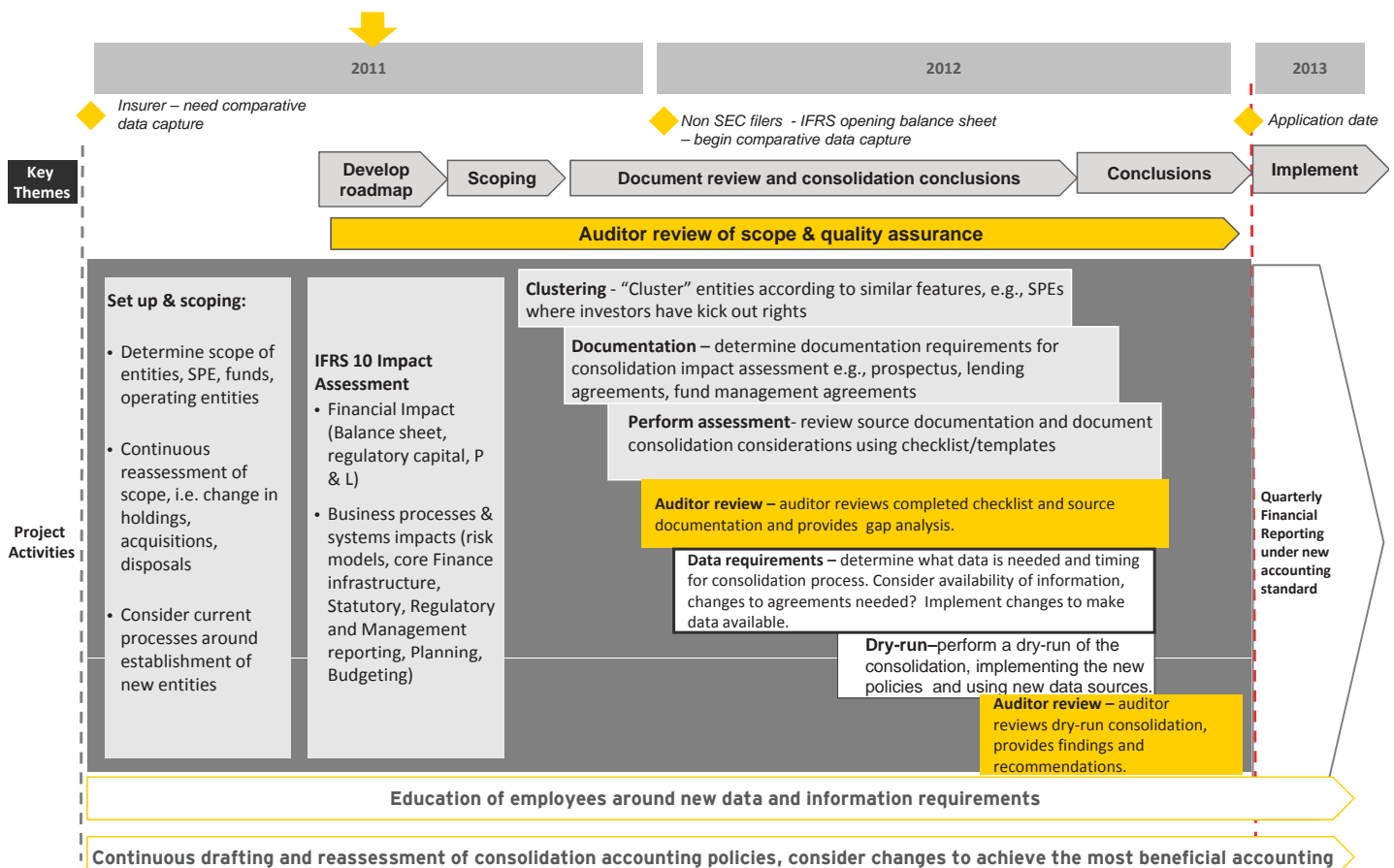
impact in advance of implementation and to make judgements on an ongoing basis.

The process of identifying the population of potential investments that require reconsideration could itself be a time consuming and difficult task. In addition, facts and circumstances that impact the assessment of control may change over time and processes would need to be adjusted accordingly.

How may Ernst & Young be able to help?

Ernst & Young has an experienced team of accounting, IFRS adoption, finance process, tax, and IT professionals to advise you in assessing how IFRS 10 and IFRS 12 will affect you and raise your level of preparedness. In the chart on the following page, we outline the challenges that are likely to be faced when preparing for IFRS 10 and IFRS 12 adoption, and describe how Ernst & Young may be able to help.

What does an insurer's consolidation roadmap look like ?



Impact of new consolidation standard on Insurers

How may Ernst & Young be able to help?

Issues and steps	How Ernst & Young can help
Understanding the technical accounting requirements of IFRS 10 and IFRS 12	<ul style="list-style-type: none"> ▶ Design and help deliver training sessions for your personnel on the accounting and financial statement disclosure implications of IFRS 10 and IFRS 12 respectively ▶ Share insights and updates from the IASB and evolving market views
Determining the impact of IFRS 10 and IFRS 12 on the financial statements	<p>Advise you on:</p> <ul style="list-style-type: none"> ▶ Gathering the necessary scoping information to implement the new standards, including providing assistance with identifying the population of entities to be considered ▶ Identifying shortfalls in available information to adopt the new standards ▶ Assessing the impact of implementing IFRS 10 on key financial ratios, performance measures and regulatory capital ▶ Developing a process for managing the significant judgements and estimates that would be necessary ▶ Identifying potential events that could trigger a re-assessment of a consolidation conclusion ▶ Developing a process to embed these consolidation re-assessment triggers into the financial statement close process
Understanding how your peer group is addressing the challenges of adoption	<ul style="list-style-type: none"> ▶ Provide observations of how others are approaching IFRS 10 and IFRS 12, problems they have encountered and solutions developed ▶ Assist in the evaluation of your position relative to your peers by sharing with you the results of our recent survey on the expected impact of IFRS 10 and IFRS 12 on an entity's financial statement close process
Assessing the impact on your key consolidation, reporting and disclosures preparation processes	<p>Advise you on:</p> <ul style="list-style-type: none"> ▶ Assessing your entity data collection and reporting processes against our leading practice model and identifying recommendations for enhancement ▶ Assessing your disclosure management processes and supporting infrastructure against our leading practice model and identifying potential efficiency and quality enhancements ▶ Identifying necessary changes to other key finance outputs and related processes and systems, including budgeting, planning and forecasting and risk reporting
Assessing the impact on tax positions arising from the adoption of IFRS 10	<ul style="list-style-type: none"> ▶ Advise you in analysing changes to tax positions arising from the adoption of IFRS 10 and strategically managing the resulting impact
Planning for adoption of IFRS 10 and IFRS 12	<p>Advise you on:</p> <ul style="list-style-type: none"> ▶ Designing the adoption timeline, based on the key finance output impact assessment described above ▶ Identifying and agreeing specific changes to entity data collection and reporting processes with local and group management ▶ Identifying and implementing changes to supporting IT systems ▶ Revising financial statements and other impacted reports
Understanding the areas where management judgement needs to be applied	<ul style="list-style-type: none"> ▶ Advise management on those areas within IFRS 10 and IFRS 12 that require the careful use of judgement ▶ Provide input into accounting manuals and policies selected by management ▶ Provide you with coordinated support to Ernst & Young subject-matter resources (Regulatory, Tax, Finance, Transformation, etc.) on a global basis
Improving your adoption readiness	<p>Advise you on:</p> <ul style="list-style-type: none"> ▶ The effectiveness of your IFRS 10 and IFRS 12 adoption project and your overall state of readiness ▶ Your data collection and reporting processes, governance and resulting reports, including areas needing improvement in advance of adoption on 1 January 2013 ▶ Your remediation plans for any areas identified requiring improvement
Stakeholder management	<ul style="list-style-type: none"> ▶ Advise on developing a communication plan for appropriate education and briefing of key internal stakeholders ▶ Engage with your external reporting and investor relations teams regarding development of a communications plan

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