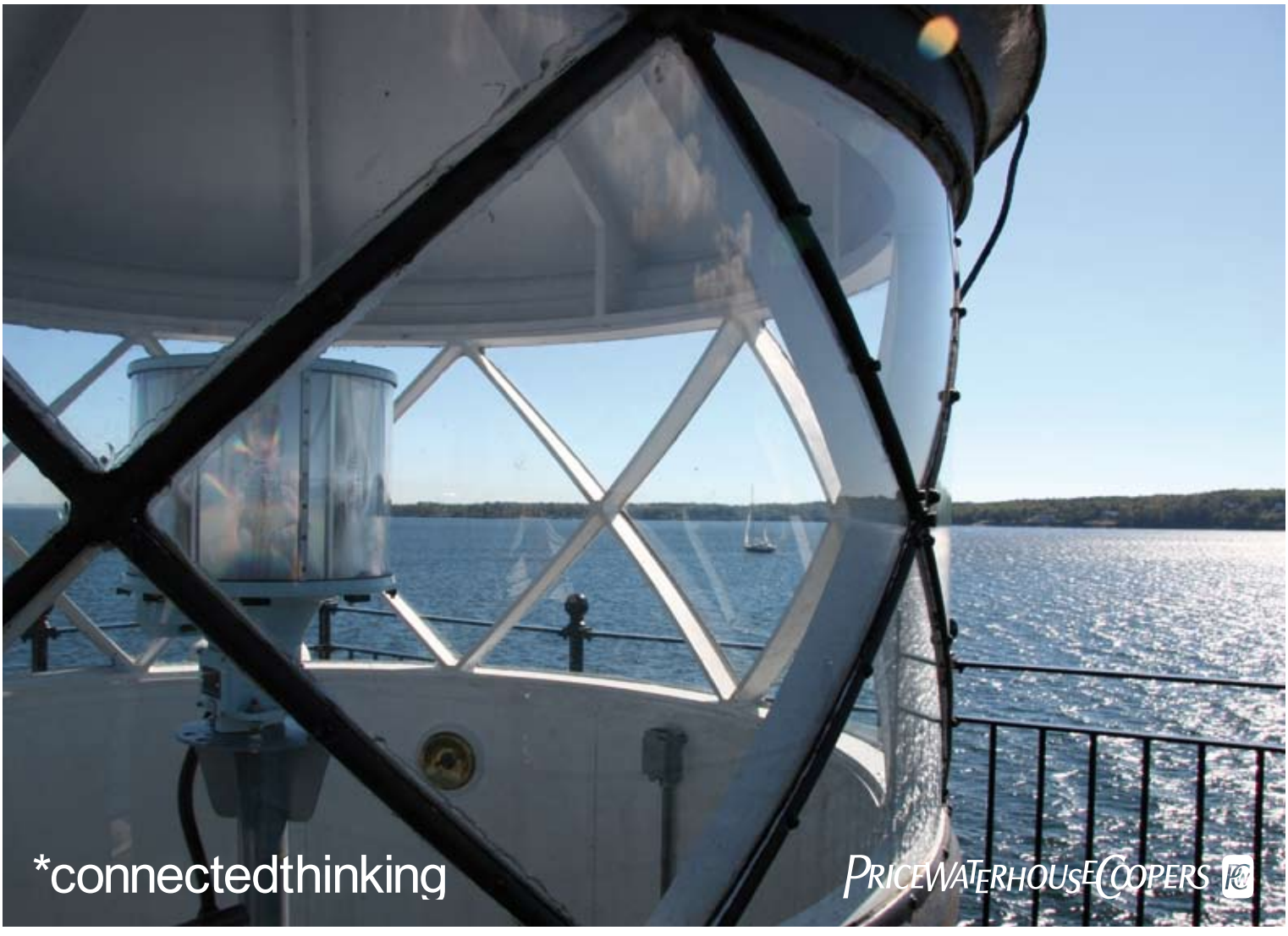
Insurance

Accounting for M&A in the insurance sector

A practical guide to IFRS and US GAAP implications

BusCom issues for insurers – December 2007



How to use this publication

This PricewaterhouseCoopers (PwC)[1] publication is for those who wish to gain a broad understanding of the accounting for M&A in the insurance sector with IFRS and/or US GAAP reporting implications.

This serves as a summary publication and, therefore, does not address the many differences of detail that exist between IFRS and US GAAP. Even if the overall approach taken in the guidance is similar, there can be differences in the detailed application, which could have a material impact on the financial statements. This publication focuses on the recognition and measurement similarities and differences most commonly found in practice. When applying the individual accounting frameworks, readers should consult all the relevant accounting standards and, where applicable, their national law. Listed companies should also follow relevant securities regulations – for example, the US Securities and Exchange Commission ('SEC') requirements and local stock exchange listing rules.

This publication takes account of authoritative pronouncements issued and in effect under IFRS and US GAAP up to 31 October 2007 applicable to M&A transactions involving insurers. However, IFRS and US GAAP continue to develop. There are various projects in progress currently with the IASB and FASB, including some joint projects, that could impact the basis for accounting for business combinations in future periods, such as IASB-FASB joint project on Business Combinations Phase II, US FAS 157 'Fair Value Measurements', and the IASB's project on Insurance Contracts. These developments are highlighted in the Epilogue to this publication but should not substitute reading the new IFRS and US GAAP standards and interpretations as and when they are issued.

1 PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

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Preface

The advent of IFRS has pushed out the frontiers of financial reporting for many insurance companies listed in Europe, and a number of other major enonomies, with more set to follow soon. It is clear that there are significant challenges posed by this new accounting regime, particularly when applying IFRS to M&A transactions.

We cannot overstate the complexities associated with business combination accounting. This accounting is required not only if an entity is bought but also in certain reinsurance transactions. Conversely this accounting may not necessarily apply to certain portfolio transfers. This is only the tip of the iceberg.

IFRS business combination accounting raises issues concerning the recognition and measurement of all acquired identifiable intangible assets. In addition, one must not forget the difficulties in measuring the acquired in-force contracts at fair value given the current lack of authoritative literature and uniform guidance available in the marketplace, which has resulted in various approaches to estimating fair value. Even the IASB has had its own difficulties in defining the fair value of an insurance contract.

Lessons learned from similar financial reporting requirements adopted under US GAAP several years back provide useful experience to assist insurers through the deep waters of IFRS for M&A deals. However, although US GAAP and IFRS are similar, there are currently differences such as the definition of what is a business, buyer's 'intent to use' the acquired identifiable intangible assets, recognition and measurement of the VBI asset on certain acquired blocks of in-force contracts, among other differences.

The challenge of business combination accounting is more than just the allocation of purchase price at the date of acquisition. Consequently, PricewaterhouseCoopers, through its engagement teams including valuation, actuarial and tax specialists, can provide valuable support extending well beyond the audit of the purchase price allocation.

I hope that you find this document useful in navigating through the accounting and valuation issues when faced with a potential M&A deal.

This document takes into account all relevant pronouncements issued and in effect up to October 2007.

Ian Dilks
Global Insurance Leader

Executive Summary

Under IFRS 3, business combinations are accounted for under the purchase method of accounting. The purchase method of accounting includes, among other things, a purchase price allocation to be performed by the acquirer. Once the acquirer is identified, the acquirer must allocate the cost of the business combination to the individual identifiable assets acquired and the individual liabilities and contingent liabilities assumed, based on their separate fair values determined at the acquisition date.[1] Any residual cost of acquisition represents goodwill. For the purposes of this publication, the purchase price allocation is referred to as the 'PPA'.

Key messages

- IFRS is still a fairly new financial reporting regime for many entities. The concepts for purchase accounting under IFRS are broadly similar to US GAAP. Lessons learned from the US GAAP experience could aid in the application of IFRS.

Many insurance entities listed in Europe and in other jurisdictions implemented IFRS on 1 January 2005. The IASB's stable platform for IFRS 2005 included IFRS 3 'Business Combinations' (IFRS 3). IFRS 3 was issued by the IASB in March 2004 to replace IAS 22 'Business Combinations', with the objective of improving the quality of and seeking international convergence on the accounting for business combinations. The financial reporting concepts concerning the PPA under IFRS 3 are not new as they existed under IAS 22. However, the application of these concepts has evolved, which has changed the financial reporting landscape for M&A deals in future periods. Given that many insurers elected not to restate business combinations prior to the IFRS transition date, they may have yet to face the issues associated with business combination accounting.[2] In addition, business combination accounting applies also to investments in associates. For further information see Chapter One.

IFRS reporters are not alone in this new financial reporting terrain. IFRS 3 was developed along similar lines to US FAS 141 'Business Combinations' (US FAS 141), which came into effect under US GAAP for all business combinations initiated after 30 June 2001. The principles underlying IFRS and US GAAP purchase accounting are broadly similar, but there are also important differences such as buyer's 'intent to use' the acquired identifiable intangible assets, recognition and measurement of the VBI asset on certain acquired blocks of in-force contracts, among other differences (see Section 1.7).[3] As US FAS 141 has been in force for several years, insurers applying IFRS 3 can benefit from the lessons learned from the application of the US standard.

- The determination of whether a business has been acquired is based on an assessment of the legal form and economic substance of the arrangement and the use of professional judgement.

Business combination accounting is based on the principle that a business has been acquired. A business is a defined term based on inputs, processes and outputs to generate future revenues. The determination of whether a business has been acquired must include consideration of the legal form as well as the economic substance of the transaction. Professional judgement needs to be exercised. This determination is not straightforward. For example, certain reinsurance arrangements may trigger business combination accounting while other transactions, such as certain portfolio transfers, may look like a business combination but do not qualify for business combination accounting. Consideration should also be given to whether the transaction is part of a larger deal that does qualify as a business combination. In the event that the transaction does not qualify as a business combination, asset purchase (or liability assumption) accounting is applied based on fair value(s) determined at the acquisition date; no goodwill is recognised; and any acquired in-force blocks of insurance/investment contracts are assessed for contract classification under IFRS and/or US GAAP, as applicable (see Section 1.1.2).

1 Under IFRS and US GAAP, certain assets or group of assets that are classified as held for sale at the acquisition date are measured at fair value less costs to sell. In addition and specific to US GAAP, the value determined for the acquired identifiable intangible assets may also consider the 'intent to use' based on buyer-specific assumptions that could lead to an IFRS-US GAAP difference (see Section 1.7).

2 IFRS 1 'First-time Adoption of International Financial Reporting Standards' included an elective exemption not to restate past business combinations that occurred before the date of transition to IFRS (IFRS 1 Appendix B paragraph B1).

3 See also the PwC publication 'Similarities and Differences – A comparison of IFRS and US GAAP' (October 2007).

- The financial reporting requirements clarify a closer link between the deal price and purchase accounting.

IFRS 3 and US FAS 141 increase the rigour required in identifying and valuing acquired identifiable intangible assets. There is a presumption that if a premium was paid over the book value on a deal, then there is a reason for it and something identifiable must have been purchased. However, in many cases, the pricing set by the dealmakers relates to the entity as a whole and not necessarily in consideration of the separate cash flow values acquired for identifiable intangible assets or acquired blocks of in-force contracts. The price will also typically include some level of expected synergies. It will often be based on a multiple of embedded value or a multiple of price-earnings with some premium that reflects how keen the potential buyer is for the target business and its business potential. This premium over quoted market multiples (for similar companies) is generally referred to as a 'control premium'. It represents the amount that is paid by the acquirer to enable the achievement of synergies given that control is being established.

The PPA should reflect what senior management communicated to the marketplace at the time of the deal. A key test to determine whether the PPA is complete is to answer the question: 'Does the PPA reflect the deal completed by management and include the separate fair values assigned to the individual identifiable assets acquired and liabilities including contingent liabilities assumed?' (see Section 1.2 and Chapter Two).

- Financial statement disclosures put the deal (and the PPA) in the spotlight to readers, analysts and capital market regulators.

IFRS 3 and US FAS 141 require qualitative and quantitative disclosures about the transaction, either individually or in the aggregate, if material. Management should consider whether the public discussion of the acquisition is consistent with the PPA and related financial statement disclosures. The disclosures enable the readers, analysts and the capital market regulators to see whether the economics of the deal matched up with what management communicated at the time of the M&A transaction. The disclosures include the reasons for the acquisition; the purchase price; the factors used to determine the purchase price that gave rise to goodwill; certain information on the opening balance sheet of the acquired business; and a statement as to whether the PPA is provisional and, if so, the reasons for the PPA not being complete (see Sections 1.6 and 3.1).

- Purchase accounting for insurers involves complex valuation issues concerning the determination of the fair values for acquired in-force insurance/investment contracts given there is relatively limited market information and a lack of uniform fair value measurement guidance.

Fair value is currently defined as the amount that would be used by a market participant to arrive at a price to be used in a hypothetical buy/sell transaction, other than in a forced liquidation. This concept applies currently under both IFRS and US GAAP, however, (i) US GAAP also currently permits buyer-specific assumptions under certain circumstances, and (ii) US GAAP introduces a new definition of fair value including guidance on how to measure fair value under US FAS 157 'Fair Value Measures' with effect from 1 January 2008 unless adopted early (see Epilogue).

The absence of frequent market comparable transactions and limited availability of market observable inputs (ie, limited principally to financial variables) necessitates the use of valuation techniques – a discounted risk-adjusted cash flow technique is commonly used. Entity-specific assumptions are permitted in the absence of market data as long as they reflect what a market participant would use. Given the lack of uniform measurement guidance, there are numerous acceptable methods currently in use in the global insurance industry to measure the fair values of acquired blocks of in-force contracts, which may include the recognition of a VBI asset for certain types of in-force contracts. Consequently, the time needed by management to determine the valuation techniques to be used and to set valuation assumptions should not be underestimated, especially if management has little experience in fair valuing insurance / investment contracts. For further information see Chapter 2.

- All acquired identifiable intangible assets are recognised and measured in the PPA.

The insurer's business is founded on contractual arrangements. Two of the more important acquired intangible assets associated with the contractual arrangements arise from direct customer relationships with policyholders (such as renewal rights and cross-selling) and/or acquired distribution channels. In addition, certain other intangibles may also be recognised including those associated with asset management or banking operations that form part of the acquired business, if material. The basis for recognition will depend on the nature of the business acquired, including the products and services offered.

The identification and measurement of acquired intangible assets requires input from accountants, actuaries and valuation specialists to determine how the projected future cash flows of the acquired business should be measured and allocated to each individual acquired intangible asset (and to the blocks of acquired in-force contracts). This can be complex because of the risk that one set of cash flows might be inappropriately used for the measurement of more than one asset or contract liability. It is therefore critical that the actuaries and the valuation experts are involved and work closely with the accountants. For further information see Section 1.2 for general requirements and Section 2.3 for intangibles specific to insurers.

- There is inevitable tension between the requirements to identify and value all acquired intangible assets and post-acquisition earnings reporting.

The financial reporting requirements can create conflicting motives in performing the PPA. Management will want to demonstrate the value of an acquisition to its investors. To the extent that investors and management focus on subsequent earnings to justify the amount spent on an acquisition, there may be sensitivity concerning the value assigned to finite-life intangible assets and the determination of their useful lives. Furthermore, the greater the residual purchase price remaining after the PPA, the higher the goodwill asset. Goodwill is not amortised but subject to an annual impairment test. Therefore, post-acquisition earnings could be subject to potential volatility arising from infrequent but sizeable impairment charges on a larger goodwill amount. For further information, see Section 2.3 for intangibles specific to insurers and Sections 3.2 and 3.4 for post-acquisition amortisation and impairment requirements, respectively.

- Appropriate due diligence, including pre-deal modelling and foresight, can help reduce costly problems or surprises that could be encountered in the post-deal phase.

Financial reporting requirements have caused participants in the M&A marketplace to critically re-evaluate existing practices when carrying out M&A deals. Based on information available at the time, pre-deal modelling of post-acquisition earnings is a crucial part of the success of many transactions. To minimise surprises for management and their shareholders, rigorous due diligence can provide an early understanding of (i) which cash flows are being acquired, (ii) what valuation issues will need to be addressed, (iii) what are the potential post-acquisition implications on earnings and return on equity (ROE), including the impact of amortising finite-life intangible assets on earnings, and (iv) the potential size of the residual goodwill balance together with a high-level assessment of the potential impairment risks arising from future annual tests. For further information see Sections 3.3 and 3.4.

… Some thoughts to take away ….

Based on the knowledge of the acquirer's business, the acquired entity's business, and the financial reporting requirements, PricewaterhouseCoopers can provide valuable advice on matters concerning the pre-deal phase, the purchase price allocation (PPA), and post-acquisition considerations. Our valuation specialists, tax specialists, actuaries and accountants can provide (where appropriate) guidance concerning insurance contract classification (if required), the determination of the valuation methodology to be used, the determination of the useful life and amortisation patterns of acquired finite-life intangible assets, consideration of which intangible assets might have indefinite lives, identifying deferred tax impacts, and addressing any related accounting issues.

Introduction

The insurance sector has experienced an increase in M&A activity in recent years (refer to the table below). Most market commentators are predicting that this activity in the insurance sector will continue in the upcoming years.

Presented in date order

Acquirer	Target	When	Local currency
Scor	Converium	various 2007	Euro 1.9bn
Liberty Mutual	Ohio Casualty Corporation	Aug 2007	USD 2.8bn
Aviva	AmerUS Group	July 2006	USD 2.9bn
Generali Group	Gruppo Toro Assicurazioni	June 2006	Euro 3.9bn
AXA	Winterthur	June 2006	Euro 7.9bn
Swiss Re	GE Insurance Solutions Corp.	June 2006	USD 7.4bn
Stone Point (private equity)	AXA Re	June 2006	USD 1.5bn
Resolution plc	Scottish Mutual, Scottish Provident and Abbey National Life	various	various
Lincoln National Corp.	Jefferson-Pilot Corp	April 2006	USD 7.5bn
Old Mutual	Skandia	Feb 2006	GBP 4.0bn
UnitedHealth Group Inc.	PacifiCare Health Systems Inc.	Dec 2005	USD 8.8bn
WellPoint Inc.	WellChoice Inc.	Sept 2005	USD 6.5bn
Consortium*	UICI Corp.	Sept 2005	USD 1.7bn
Aviva	RAC	May 2005	GBP 1.1bn
Eureko	Interpolis	April 2005	Euro 3.4bn
MetLife Inc.	Travelers Life & Annuity Co./CitiInsurance International Hldgs	Jan 2005	USD 11.5bn

** led by Blackstone Group, private equity*

In a business combination, the acquirer applies the purchase method of accounting. One element of the purchase method of accounting is the purchase price allocation (or PPA).[1] The purchase method of accounting is a concept that has existed under IFRS since 1983 and under other national GAAPs including US GAAP as far back as 1970.[2] So what has changed? The answer is the issuance of new standards in IFRS and US GAAP in recent years, which have increased the rigours of identifying and measuring all identifiable intangible assets acquired.[3] These new standards have increased the complexities that insurers must face when they apply business combination accounting. Consequently, the financial reporting impacts of a deal considered during the pre-deal modelling phase should take account of the potential implications arising from the PPA as well as the potential post-deal financial reporting impacts.

This publication is split into three sections: general financial reporting concepts for business combination accounting for insurers (Chapter One); specific guidance concerning the PPA (Chapter Two); and some post-acquisition considerations (Chapter Three). Useful insights and tips are highlighted in comment boxes throughout this document and certain key terms used throughout are defined in the Glossary. It addresses practical accounting and valuation issues for business combinations involving insurers including:

- The types of insurance-related transactions that could trigger business combination accounting;
- The issues concerning the fair value measurement of insurance and investment contract liabilities due to limited market data and a lack of uniform guidance on measurement;

1 Purchase Price Allocation (or PPA) – see Glossary for definition and reference to other similar terms that are used to describe this process.

2 The concepts of purchase method of accounting can be found in IAS 22 'Accounting for Business Combinations' (IAS 22) issued in November 1983 and under US GAAP Accounting APB Opinion 16 'Business Combinations' (US APB 16) that came into effect in 1970.

3 IAS 22 was replaced by IFRS 3 which came into effect during 2004. US GAAP APB 16 was replaced by FAS 141 'Business Combinations' (US FAS 141), which came into effect during 2001.

- The issues concerning the identification, measurement and subsequent amortisation of acquired identifiable intangible assets;
- The accounting for changes to the PPA during the allocation period and after the PPA is completed, especially given the long-term nature of insurance business;
- The post-acquisition issues associated with goodwill impairment testing, such as developing valuation methods and identification of triggering events;
- The practical issues concerning post-acquisition financial reporting which could affect insurers; and
- The broad similarities and differences specific to insurers between the IFRS requirements and similar requirements under US GAAP, as IFRS 3 was developed from the equivalent standard in US GAAP (ie, US FAS 141).[1]

General accounting issues applicable for all business combinations, including current IFRS – US GAAP differences, are not addressed in this document. Guidance can be found in other PwC publications on these general issues which include the identification of the acquirer; reverse acquisitions; determination of acquisition date; contingent consideration; restructuring provisions; contingent liabilities including litigation and indemnification agreements; minority interests at acquisition; curtailment or settlement of employee benefits; share-based compensation; and accounting for the buyout of minority interests.[2]

As IFRS and US GAAP standards and practices will continue to evolve and possibly converge in the coming years, the future of business combination accounting involving insurers will change. Some of the current IASB and FASB developments that could eventually affect business combination accounting involving insurers include the IASB's Insurance Contracts Phase II project, and the IASB-FASB projects on Business Combinations Phase II and Fair Value Measurements which are briefly described in the Epilogue at the end of this document.

1 See PwC publication 'Similarities and Differences – A comparison of IFRS and US GAAP' (October 2007).

2 This publication was based on IFRS and IFRIC text in effect at 31 October 2007. The information concerning US GAAP was based on original text including Specialised Industry Accounting Guidance including related PricewaterhouseCoopers US Datalines at 31 October 2007. Further general PwC guidance on this topic can be found in Comperio (i.e. www.pwccomperio.com). See also PwC publication 'Similarities and Differences – A comparison of IFRS and US GAAP' (October 2007).

Chapter one

Financial Reporting Concepts for M&A deals

The information provided in this chapter serves as a reminder of the general financial reporting requirements for business combinations accounting under IFRS and US GAAP.

This chapter explores the following topics:

1.1 Financial reporting for business combinations under IFRS and US GAAP

1.1.1 General commentary

Business combination accounting is applied when a business is acquired. Business combinations are accounted for using the purchase method of accounting under IFRS and US GAAP.[1] As part of the purchase method of accounting, the cost of the business combination is allocated to the individual assets acquired and the individual liabilities assumed based on their separate fair values determined at the acquisition date.[2] Any excess or deficiency in the purchase price over the fair value of the acquired assets and assumed liabilities is attributed to goodwill or negative goodwill, respectively (see Section 1.3). This process, referred to as a purchase price allocation (PPA), is further discussed in Chapter Two.

1.1.2 A business combination occurs if a business has been acquired

A business combination is defined under IFRS and US GAAP as a transaction that brings together separate entities or businesses into one reporting entity and the acquirer obtains the control of the acquired entity.[3] A business is considered an integrated set of activities consisting of inputs, processes applied to those inputs, and resulting outputs that are used to generate revenues.[4] The transferred set of activities should be able to conduct normal operations after the transfer and should be able to provide an economic return. The elements of inputs, processes and outputs will vary by industry and, specific to insurance, may include:

Inputs	Employees and assets to support the insurance business activities
Processes	Systems including the policy administration systems, pricing and underwriting and other operational processes
Outputs	The ability to obtain access to the customers that will purchase the outputs such as in-house sales force or a distribution channel such as agents, brokers, etc.

The IFRS principle of what constitutes a business is broadly in line with US GAAP, albeit US GAAP focuses on whether the integrated set of activities is 'self-sustaining'[5]. This could lead to a possible IFRS-US GAAP difference on application depending on the facts and circumstances involved (see Section 1.7).

If a business has not been acquired, then the transaction does not qualify for business combination accounting. In this circumstance, the transaction may be accounted for as an asset purchase (liability assumption) whereby: (i) the cost of acquisition is allocated to the assets acquired (liabilities assumed) based on estimated fair values at the transaction date; (ii) there is no recognition of goodwill; and (iii) for transactions involving the transfer of insurance/investment contracts, there are special considerations concerning assessment of contract classification at transaction date.[6] In certain cases, when the transaction does not qualify as a business combination, it may be accounted for as a reinsurance transaction depending on the facts and circumstances involved (refer to illustrative examples provided in Section 1.1.3 below).

1 **IFRS:** The general guidance concerning IFRS accounting for business combinations can be found in IFRS 3 'Business Combinations' (IFRS 3). This is supplemented by guidance found in IAS 38 'Intangible Assets' (IAS 38) for the identification and recognition of intangible assets, IAS 37 'Provisions, Contingent Liabilities, and Contingent Assets' (IAS 37) for the recognition of liabilities associated with (i) onerous contracts for contractual arrangements of the acquired that are no longer needed, and (ii) employee termination arrangements for employees of the acquired entity. The guidance for post-acquisition impairment testing is found in IAS 36 'Impairment of Assets' (IAS 36). IFRS 4 'Insurance Contracts' (IFRS 4) provides certain additional guidance concerning business combinations.

US GAAP: The accounting for business combinations is found in various sources including US FAS 141 Business Combinations (US FAS 141), US FAS 142 'Goodwill and Other Intangible Assets' (US FAS 142), and US FAS 144 'Accounting for the Impairment or Disposal of Long-Lived Assets' (US FAS 144), and specific to insurers US EITF 92-9 'Accounting for the Present Value of Future Profits Resulting from the Acquisition of a Life Insurance Company' (US EITF 92-9).

2 Allocation of the cost of the business combination is found in IFRS 3 paragraphs 36 to 40 and US FAS 141 paragraphs 35 to 36.

3 Definition of a business combination: IFRS 3 paragraph 4 and US FAS 141 paragraph 9, however, a new entity can be formed to issue equity instruments to effect a business combination as well (IFRS 3 paragraph 22 and US FAS 141 paragraph 19).

4 IFRS definition of a business is provided in IFRS 3 Appendix and is also described in the Glossary.

5 US GAAP definition of a business is provided in US FAS 141 paragraph 9 and related guidance found in paragraph 6 of US EITF Issue No. 98-3 'Determining whether a non-monetary transaction involves receipt of productive assets or of a business', and is also described in the Glossary.

6 IFRS 3 paragraph 4.

… Thoughts to take away for transactions that do not qualify for business combination accounting …

Business combination accounting can only be applied if an entity or a business was acquired.

Depending on the facts and circumstances involved, transactions that do not qualify as a business combination may qualify for reinsurance accounting or for accounting as an asset purchase (liability assumption) that would include (i) fair value measurement, (ii) recognition of acquired identifiable intangible assets, and (iii) assessment of contract classification on transferred blocks of in-force insurance/investment contracts.

Concerning points (i) and (ii) above and based on current fair value measurement literature in effect, the consideration paid is deemed to be the best indication of fair value in the absence of evidence to the contrary available in the market. Acquired identifiable intangible assets can be recognised so long as they meet the requirements for recognition under IFRS and US GAAP, as appropriate (see Sections 1.2 and 2.1). The requirement to fair value acquired in-force contracts and to recognise and measure acquired intangible assets (specific to insurers) are the same as those for business combination accounting with one exception, goodwill is not recognised (see Sections 2.1-2.3 for further guidance on recognition and measurement at fair value).

Concerning point (iii) above, in a liability assumption transaction (eg, certain portfolio transfers) the original insurer is relieved from its obligations to the policyholders and, therefore, may recognise a profit or loss on extinguishment. A new contractual relationship has been created between the acquirer and the policyholder. Even though the terms and conditions of the underlying contract may not have changed since original inception, it is a new contract to the acquirer. Consequently, under both IFRS and US GAAP, this type of transaction requires an assessment of contract classification at acquisition date.

Example under IFRS: LifeCo issued a 15-year contract in 2000 that had significant insurance risk in the first five years and no insurance risk in the last ten years. At contract inception, the 15-year contract was classified as an insurance contract: the contract at original inception was an insurance contract for LifeCo and would have remained as such under IFRS4. In 2007, LifeCo transferred the book of contracts that included this contract to Epargne Insurance. At acquisition date, the 15-year contract no longer bears insurance risk. Epargne Insurance acquired a contract which, at the time of transaction, transferred only financial risk. The rights and obligations under this acquired contract represent a new relationship that did not previously exist between the reporting group and the policyholder. Epargne Insurance is required to assess contract classification at the inception of this contract (ie, at transaction date): it is an investment contract at transaction date for Epargne Insurance.

The process for identifying and valuing all intangible assets acquired must be rigorous, as no goodwill is recognised. If an entity's initial allocation results in the cost of a group of acquired assets exceeding the sum of the fair value of the individual assets, then the entity should consider whether any assets were overlooked and reassess its fair value estimates. Careful consideration should be given to any remaining excess.

1.1.3 Legal structure of transaction alone does not determine whether a business has been acquired

M&A transactions can be structured in various ways. Not all M&A transactions qualify for business combination accounting because it depends on whether a 'business' has been acquired. This section explores certain types of transactions involving insurers that may or may not trigger business combination accounting and why.

Some transactions involving insurance companies can be fairly straightforward, such as where one entity acquires another entity's shares and obtains control (for example, the Old Mutual acquisition of Skandia completed in 2006). However, insurers can also be involved in other transactions that can be perceived as business combinations, but may not in fact qualify as such for accounting purposes (for example, certain portfolio transfers for which only the portfolio of in-force contracts is transferred from one party to another). On the other hand, certain transactions that were not legally structured as business combinations could end up being accounted for as such because it has been deemed that a business has been acquired (for example, certain reinsurance arrangements that are in fact part of a larger transaction).

The table below indicates whether particular types of transaction would qualify for business combination accounting.

Legal structure of transaction	Principal feature	Business combination?
Acquisition of an insurance operating entity	Acquirer obtains control of the acquired entity	Yes, unless it is a shell entity or what was acquired does not constitute a business *Need to consider facts and circumstances*
Reinsurance (indemnification)	Reinsurer indemnifies cedant, but the obligations to the policyholders remain with the cedant	No, unless part of a larger transaction involving employees, intellectual property, systems *Need to consider facts and circumstances*
Reinsurance (novation)	Reinsurer assumes the contractual obligations of the unexpired portion of original risk	It depends on whether a business has been acquired and whether there is business continuity *Need to consider facts and circumstances*
Portfolio transfer of insurance contracts (Europe)	Transfer of a block of contracts from one insurer to another insurer	It depends on whether a business has been acquired and whether there is business continuity *Need to consider facts and circumstances*

Consideration of whether a business has been acquired should include whether the rights and obligations of the underlying in-force block of contracts have been transferred from one party to another, whether the employees/staff and systems have been transferred (among other things), and whether the transferred set of activities is revenue generating to provide an economic return. This analysis can be complicated when outsourcing is involved. The types of transactions presented in the table above could, under certain facts and circumstances, trigger business combination accounting.

The conclusion on whether business combination accounting applies ultimately depends on the facts and circumstances of the transaction in question, including (i) the legal form and substance of the arrangement, and (ii) whether the transaction itself is part of a larger deal in which case the overall larger transaction should be evaluated, in the aggregate, to determine whether it qualifies for business combination accounting.

Illustrative types of transactions:

Case study one: Acquisition of a continuing business

Insurer A acquires Insurer B for cash and an exchange of ordinary shares. Following the acquisition, the business of Insurer B including the assets, the contractual liabilities, the policy administrative systems, the distribution channels, the financial reporting systems and the employees fall under the control of Insurer A. The contractual rights and obligations of the underlying insurance contracts in the acquired insurance entity's portfolio remain between Insurer B and the policyholder, even though the operations may in time be merged into the acquirer's operations.

Conclusion – Insurer A acquired a set of integrated activities that meets the definition of a business. The transaction qualifies for business combination accounting under the purchase method.

Case study two: Acquisition of a limited scope business

Insurer C is a subsidiary of a larger reporting group. Insurer C holds a limited number of in-force insurance contracts that originated from other entities within Insurer C's former group. Insurer A acquires Insurer C's insurance contracts, which are in run-off whereby the future activities will be limited to renewal activity. The assets, the employees and the systems of Insurer C are also acquired by Insurer A.

Conclusion – Insurer A has acquired a set of integrated activities (ie, a business). Even though the acquired business is in run-off, if Insurer A is capable of providing benefits to customers and generating an economic return in future periods arising from the renewals on existing contracts, then this transaction would qualify as a business combination. In other words, even though the business is in run-off, a service will still be provided to collect renewal premiums, to administer renewal policies, and to provide other ongoing policyholder services that generate operating revenue. Note: If the employees and systems were not acquired as part of the transaction, then it may be unlikely that the transaction would qualify as a business combination; however, it comes down to the facts and circumstances involved.

Case study three: Reinsurance indemnification arrangement

Insurer B writes non-participating whole life insurance contracts that are reinsured (ceded) to Insurer A (a reinsurer). Insurer B's rights and obligation of the underlying insurance contract to its policyholders remain unchanged. The policyholders are not aware of this transaction as it does not require policyholder approval. This transaction is not part of a larger transaction.

Conclusion – The inputs, processes, and outputs of the Insurer B's operations are not transferred to Insurer A but instead remain with the Insurer B. A business has not been acquired. This transaction does not qualify as a business combination. In this case, a new relationship has been created between Insurer B and Insurer A. Depending on whether there is significant insurance risk transfer, the contracts may qualify for insurance or reinsurance contract accounting under IFRS and US GAAP, as appropriate.

Case study four: Reinsurance novation[1] arrangement with business continuity transferred

Insurer B writes automobile insurance contracts. Insurer B wishes to exit the automobile insurance market to focus principally on providing health insurance going forward. Insurer A is interested in expanding its market share in the automobile insurance sector. Insurer A issues an assumption agreement with Insurer B through which Insurer A will take over the rights and obligations of Insurer B's automobile insurance contracts. Insurer B will be novated (removed) from its existing rights and obligations to its policyholders. To complete this transaction, all policyholders sign a certificate to approve the transfer of their policies to Insurer A. Policyholders can refuse to sign and can cancel their

1 The legal requirements for novations can be vague and may vary from jurisdiction to jurisdiction (indeed, in the US it can vary from state to state). The form of consent can vary from a 'written policyholder consent' to 'premium payment being assumed consent'. It is typically subject to a policyholder's right to object to the transfer within a specified period of time and there could be other schemes of policyholder consent. As a result of the myriad of policyholder consent schemes and large number of policyholders typically involved, it may be rare in certain jurisdictions (such as in the US) for an insurer to cede block of contracts under reinsurance assumption arrangement to extinguish its policy obligations for GAAP accounting purposes, except where the policyholder agrees to the substitution of the assuming company for the ceding company.

policies without penalties. The terms of the arrangement also include Insurer A taking over Insurer B's employees including its in-house sales force and the policy administration systems. Insurer A will write automobile insurance on 'its own paper' using Insurer B's product designs and transferred employees.

Conclusion – Insurer A has assumed (ie, taken control of) Insurer B's automobile insurance business including its inputs, processes and outputs that are expected to generate future economic benefits. Therefore, a business has been acquired. Note: if Insurer A continued to use its own employees and own systems to manage Insurer B's run-off business, then the reinsurance assumption would be limited to claims liabilities and the unexpired portion of risk, in which case business combination accounting would not be applied as a business would not have been acquired.

Case study five: Reinsurance indemnity arrangement that forms part of a larger transaction

Insurer A enters into a reinsurance arrangement with Insurer B. Insurer A will reinsure Insurer B's existing annuity business in-force. Insurer B retains the rights and obligations to the policyholders on those contracts ceded to the reinsurer. In addition and at the same time, another agreement is established where Insurer A pays Insurer B to use Insurer B's agency channel, employees and systems to write new annuity business on behalf of Insurer A.

Conclusion – Consideration needs to be given to the facts and circumstances involved. The reinsurance arrangement is part of a larger transaction that appears to be transferring the inputs, processes and outputs of the future new business to Insurer A. Insurer A has obtained the continuity of the annuity business in future periods. Based on the facts and circumstances, the overall transaction qualifies for business combination accounting.

Case study six: Portfolio transfers

A 'portfolio transfer' is a term commonly used to refer to an acquisition by one insurer of a block of insurance business from another insurer. The basis by which a portfolio transfer is completed will vary across jurisdictions and may depend on policyholder, insurance regulator and/or legal court approval in order to protect the interests of the policyholders. The structure of these types of transactions can differ: portfolio transfers that transfer only the portfolio of in-force contracts would not qualify for business combination accounting, whereas other portfolio transfers that also include the transfer of the assets, the operating systems, the employees and the distribution channels could qualify for business combination accounting.

Conclusion – The facts and circumstances of each portfolio transfer need to be evaluated separately to determine if a business has been transferred (ie, acquired). The determination should consider factors described in other case studies provided in this section.

Case study seven: Acquisition of renewal rights

In a renewal rights transaction, Insurer D is a non-life insurer and wishes to exit a segment of non-life insurance in a certain geographic area. Insurer D agrees to facilitate placement of renewals with another non-life insurer (Insurer A) in exchange for consideration. The consideration is in the form of a percentage of premiums from existing policyholders for a specified period of time. The substance of the transaction is similar to assumption reinsurance; however, Insurer A (assuming entity) does not take responsibility for Insurer D's (ceding entity) existing claims liabilities and unearned premium liabilities and any potential adverse development on those in-force contracts.

Conclusion – If significant workforce, distribution channels, systems and other elements accompany the renewal rights transaction, the substance of the acquired elements may constitute a business and business combination accounting would apply. However, if the transaction is limited to the transfer of renewal rights only, then it is likely that a business combination has not occurred: the renewal rights are recognised at fair value at transaction date and no goodwill is recognised.

… Some thoughts to take away ...

M&A transactions involving insurers can be accomplished through various forms. It is important to understand the facts and circumstances of the transaction including the terms and conditions of the legal arrangement, the economic substance of the transaction, and whether the transaction is part of a larger deal.

Management needs to ask the question 'did one party acquire a business from another party?' If the answer is yes, then business combination accounting is applied. If the answer is no, then asset purchase (liability assumption) accounting is applied as described in Section 1.1.2.

To decide if a business combination has occurred, the following types of questions should be answered (Insurer A is the acquirer (or reinsurer) and Insurer B is the acquired entity (or cedant)).

- Are the management, employee workforce and /or back-office administrative functions of Insurer B being transferred to Insurer A?
- Does Insurer A have the contractual right to write/sell new products to Insurer B's existing in-force customer base or through Insurer B's agency force (ie access to Insurer B's distribution channels)?
- Can Insurer A use the trademark/brand of Insurer B?
- Does the transaction include the transfer of product manufacturing and marketing functions of Insurer B including product development and pricing to Insurer A?
- Are any licences of Insurer B necessary to sell insurance contracts in that jurisdiction, and, if so, have they been transferred to Insurer A?
- Is this transaction part of a larger deal involving Insurer A and Insurer B or their related parties?
- Is the block of in-force contracts transferred to insurer A in run-off?

The above should not be used as an all-inclusive checklist. If some of the elements above are missing, the transaction could still qualify as a business combination if the missing element(s) can be added with minimal investment or outsourced.

1.2 Intangible assets identified in business combinations

IFRS and US GAAP do not permit the entity to choose which intangible assets to recognise in the PPA. As part of the PPA, both IFRS and US GAAP require the buyer to recognise separately each of the intangible assets acquired. However, the application of that concept under IFRS and US GAAP could differ.

Both IFRS and US GAAP state that recognition is based on whether it meets the definition of an intangible asset, which requires such asset to be identifiable. To be identifiable, the asset is either:

a. arising from a contractual or legal right, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations, or

b. separable, in other words, capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability.

However, IFRS also requires that the asset be measured reliably: there is a rebuttable presumption that an intangible asset arising in a business combination should be recognised unless (i) it is not separable, or (ii) it is separable, but it cannot be reliably measured because of a lack of history or evidence of exchange transactions for the same or similar assets and otherwise. While IFRS and US GAAP indicate that sufficient information should exist to measure the fair value of an asset or liability,[1] this could result in an IFRS-US GAAP difference, although in our view it is likely to be difficult to sustain (see Section 1.7).

Refer to Section 1.7 for IFRS-US GAAP differences, Section 2.1 concerning fair value measurement, Section 2.3 concerning measurement of acquired intangible assets, and Sections 3.2 and 3.4 concerning subsequent amortisation and impairment of finite-life intangible assets, respectively.

Please note that the basis for recognising and measuring acquired intangible assets is evolving as a result of the IASB-FASB joint project on 'Business Combinations: Applying the Acquisition Method'. This is further discussed in the Epilogue.

1 IAS 38 paragraphs 35–41: the fair value of intangible assets acquired in business combinations can normally be measured with sufficient reliability to be recognised separately from goodwill. US GAAP FAS 141 paragraph B152: sufficient information should exist to reliably measure the fair value of that asset if an asset has an underlying contractual or legal basis or if it is capable of being separated from the entity.

The general types of intangible assets that could be identified in a business combination are provided in the table below. The table is from US FAS 141[1] and its contents are repeated in IFRS 3 Illustrative Examples.

		Principally Contractual or Legal right	Principally Separable
Marketing-related	Trademarks, trade names *(Brands)*	Yes	
	Service marks, collective marks, certification marks	Yes	
	Trade dress, newspaper mastheads	Yes	
	Internet domain names	Yes	
	Non-competition agreements	Yes	
Customer-related	Customer lists *(name and contact data, or form of database)*		Yes
	Order or production backlog	Yes	
	Customer contracts and related customer relationships	Yes	
	Non-contractual customer relationships		Yes
Contract-based	Licensing, royalty, standstill agreements	Yes	
	Advertising, construction, management, service or supply contracts	Yes	
	Lease agreements *(Favourable)*[2]	Yes	
	Construction permits	Yes	
	Franchise agreements	Yes	
	Operating and broadcast rights	Yes	
	Use rights such as drilling, water, air, mineral, timber cutting, and route authorities	Yes	
	Servicing contracts such as mortgage servicing contracts[3]	Yes	
	Employment contracts	Yes	
Technology-based	Patented technology	Yes	
	Computer software and mask works	Yes	
	Unpatented technology		Yes
	Databases		Yes
	Trade secrets, such as secret formulas, processes, recipes	Yes	
Other	Assembled workforce	No*	No*

** Assembled workforce is subsumed with goodwill.*

Acquired intangible assets specific to business combinations involving insurers are addressed in Section 2.3.

1 US FAS 141 table is provided in paragraph A14. The treatment of assembled workforce is provided in paragraph 39 with further examples provided in US FAS 142 paragraph A1, including examples of customer lists, licences, etc.

2 Arrangements such as lease agreements can be unfavourable relative to current market prices at the acquisition date and should also be included in the PPA (US FAS 141 paragraph A10 and footnote 28 and IFRS 3 paragraph 44.

3 For IFRS and US GAAP, a distinct asset (or liability) can be recognised either when contractually separated from the underlying financial asset by sale or securitisation of the assets with service retained, or through the separate purchase and assumption of the servicing. If financial assets are acquired with servicing retained, then the servicing right is not a separate intangible asset because the fair value of those rights are included in the fair value measurement of the acquired financial asset (IFRS 3 Illustrative Example D8 and US FAS 141 paragraphs A23–A24).

In addition, certain jurisdictions permit insurers to recognise a VBI asset[1] that is, in fact, part of the fair value of liability associated with the acquired in-force block of contracts. The VBI asset is permitted for insurance and investment contracts under US GAAP. Under IFRS, the recognition of a VBI asset is permitted for insurance contracts and, we believe, it can also be applied to investment contracts with discretionary participating features (DPF) in the scope of IFRS 4. However, investment contracts without DPF do not have a VBI asset, but may recognise some other type of asset.

Assets associated with the fair value adjustment to the contract liability are addressed in Section 2.2.1 for non-life insurance contracts, Section 2.2.2.2 for contracts with mortality / morbidity risk and Section 2.2.2.4 for investment contracts with and without DPF. Differences between US GAAP and IFRS arising from the recognition of acquired intangible assets are further described in Section 1.7.

The process by which the buyer has identified, recognised and measured the intangible assets acquired is important, including (i) the nature and extent of the business acquired and how it aligns with the acquirer's business, and (ii) whether the identified acquired intangible assets are consistent with communications by management to the external marketplace and internal papers provided to the Board of Directors and Audit Committee.

1 The VBI asset is described in Section 2.2.2 and is also defined in the Glossary.

1.3 Accounting for the residual cost of the acquisition

1.3.1 Excess of purchase price versus excess of fair value

Under IFRS and US GAAP, the difference between the cost of the business combination and the sum of the individual fair values assigned to the identifiable assets acquired and liabilities (including contingent liabilities assumed) represents a residual amount that is recognised as one of the following:

- The excess of the purchase price over the fair value of the acquired identifiable net assets is recognised as a goodwill asset; or
- The excess of fair value of acquired identifiable net assets over the purchase price, commonly referred to as 'negative goodwill', triggers a reassessment (i) of the fair values assigned to the individual identifiable assets acquired and liabilities (including contingent liabilities assumed), and (ii) of the purchase price including contingent consideration.

It is more common to see a goodwill asset. The residual goodwill asset reflects the amount paid by the acquirer in anticipation of future economic benefits from assets that are not capable of being individually identified and separately recognised for financial reporting purposes at acquisition date, such as the acquired entity's employee workforce and/or acquirer's synergies, etc.[1] An illustrative example is provided on the next page.

Nevertheless, negative goodwill can occur, typically in special situations that result in a bargain purchase: for example if an insurer is keen to exit a business line or a geographic location. Both the IASB and FASB have indicated that if the PPA has been properly performed, such instances should be rare.[2] If negative goodwill arises, then consideration should be given to the treatment of the excess fair value of net assets acquired over purchase price, which is different under IFRS and US GAAP (see Section 1.7).

IFRS and US GAAP both require 'reassessment' but the process and measurement requirements differ.

Please note that the basis for recognising goodwill in a bargain purchase is evolving as a result of the IASB-FASB joint project on 'Business Combinations: Applying the Acquisition Method', the timing of which is addressed in the Epilogue.

1 IFRS 3 paragraphs 52–53 and US FAS 141 paragraph 43.

2 IASB and FASB indicate that an 'excess' should rarely remain if the valuations inherent in the business combination accounting (the PPA) have been performed properly and all liabilities and contingent liabilities have been identified and measured at fair value (IFRS 3 paragraph BC147 and US FAS 141 paragraph B187).

Disclosure under IFRS concerning the residual value attributed to goodwill
Source: Old Mutual 2006 Consolidated Financial Statements (acquisition of Skandia)

The fair value of the assets and liabilities acquired was as follows:

£m

	Book value	Fair value and accounting policy adjustments	Acquired intangibles	Fair value as reported at 31 December 2006
Assets				
Intangible assets	52	(41)	3,036	3,047
Deferred acquisition costs (DAC)	1,422	(1,422)	–	–
Deferred tax assets	40	(5)	–	35
Other assets	39,366	(270)	–	39,096
Total assets	40,880	(1,738)	3,036	42,178
Liabilities				
Deferred revenue liability (DRL)	1,214	(1,214)	–	–
Provisions	89	99	–	188
Contingent liabilities	–	63	–	63
Deferred tax liabilities	234	(109)	500	625
Other liabilities	38,426	(18)	–	38,408
Total liabilities	39,963	(1,179)	500	39,284
Net assets acquired	917	(559)	2,536	2,894
Less: Minority share of net assets acquired				(29)
Residual goodwill				1,130
Total consideration				3,995

The fair value of the net assets and acquired intangibles has been updated following revisions to original estimates in the fourth quarter of 2006. The calculation of residual goodwill will be finalised in 2007.

Separate intangible assets have been identified and valued at £3,036 million, using estimated post-tax cash flows and post-tax discount rates. These intangibles represent the value of the PVIF, the values of the Skandia distribution network, customer relationships in respect of non-life businesses, and the Skandia brand. No other intangibles were identified which were capable of reliable measurement. A deferred tax liability of £500 million has been provided for in respect of these intangible assets, based on the tax rates applicable in the various territories, on the grounds that the assets have no tax base, thereby creating temporary differences on which deferred tax must be provided.

The useful economic lives of the PVIF and other intangibles have been assessed, taking into account factors such as the usage of the asset, life cycles, obsolescence, maintenance, and period of control over the asset. PVIF and other intangible assets will be amortised over a period of between 10 and 20 years. Related deferred tax liabilities will be amortised in line with the amortisation of the particular intangible asset.

Other fair value adjustments principally comprise the derecognition of DAC, DRL and related balances (including deferred tax impacts thereon) on the basis that these items have no fair value at acquisition. These items are included in the calculation of the PVIF.

The remaining fair value and accounting policy adjustments relate to the derecognition of goodwill shown in Skandia's balance sheet, recognition at fair value of certain assets and liabilities previously recorded at amortised cost in Skandia's balance sheet, and other adjustments to reflect up to date estimates in respect of certain litigation issues and tax, including the recognition of certain contingencies.

Of the fair value and accounting policy adjustments shown above, £147 million relates to reductions in net assets determined in the final quarter of 2006 on the basis of new information that has become available subsequent to the publication of the Group interim financial statements to 30 June 2006.

The residual goodwill of £1,130 million represents the value of the Skandia workforce and synergies, both from increased revenues and reduced costs which are expected to arise across the Skandia business and within our UK life assurance operations as a result of the acquisition. It also represents the value of new business growth and other customer intangible assets which cannot be reliably measured.

1.3.2 Goodwill asset and foreign currency translation

M&A deals involving insurers can occur across jurisdictions in currencies that differ from the functional currency of the acquirer.

Both IFRS and US GAAP require that goodwill and the fair value adjustments to assets and liabilities that arise on the acquisition of a foreign business be treated as part of the assets and liabilities of the acquired business for consolidation purposes, translated at the closing rate for the presentational currency at the reporting date.[1]

Even if the goodwill is recorded in the acquirer's books[2] and relates to an acquisition performed in the functional currency of the acquirer, the goodwill on a foreign subsidiary will give rise to subsequent foreign currency adjustments regardless of whether they are recorded in the books and records of the acquired foreign operation or the parent company.

For example, InsurGroup is a German insurance group with a functional currency and presentational currency in Euros. InsurGroup acquires Tokyo Life Company whose functional currency is Japanese Yen. The fair value of the individual assets acquired and individual liabilities assumed including goodwill is reported in Yen and, for group reporting purposes, is translated to Euros at the reporting date, even if the purchase price was in Euros and the goodwill is recorded in InsurGroup's books.

The accounting is not complicated in principle but should be considered carefully when preparing the consolidated financial statements of the acquirer.

1 IAS 21 revision paragraph IN 15 and US FAS 52 paragraph 12.

2 Under certain circumstances in the US, the SEC requires 'push-down' accounting whereby the goodwill is actually reflected in the local entity's accounting records. There is no equivalent under IFRS (see Section 1.7 and 2.5.5). However, in cases where 'push-down' accounting is not required, it is likely that the goodwill remains on the books of the acquirer rather than being 'pushed-down' to the books of the subsidiary.

1.4 Applicability to acquisitions of associates

Investments in associates do not result in either control or joint control by the investor, but rather enable the investor to have significant influence over the operating and financial policies of the investee. Under IFRS and US GAAP, significant influence is presumed if more than 20% of the voting ownership interest is held directly or indirectly through subsidiaries. However, depending on the facts and circumstances involved, this could also apply to holdings of less than 20%.[1]

Business combination accounting applies to investments in associates. These investments are initially recognised at cost, which is subsequently increased or decreased based on the investor's share of net income and reduced for dividends distributed. The cost of acquisition on day one is allocated to the individual assets acquired and liabilities assumed of the associate, as in a business combination. Consequently, equity method goodwill could be recognised.[2] In line with business combination accounting for a subsidiary, an opening balance sheet will be established for the associate based on fair values assigned to the individual assets acquired and liabilities, including contingent liabilities assumed. The post-acquisition accounting should be based on the investor's accounting policies and should include amortisation of finite-life intangible assets acquired and equity method goodwill impairment, if any, to determine the investor's share of net income for the period and cost of investment at reporting date.

The principles for equity method accounting are similar between IFRS and US GAAP. However, there can be differences in the underlying valuation of assets and liabilities, which impact the determination of the investors share of net income. Equity method goodwill impairment is described in Section 3.4.

…some thoughts for insurers…

- There is a general tendency to overlook business combination accounting for investments in associates. Indeed, this has led to restatements in the US marketplace.
- Because the investor does not control the associate, the acquirer may not necessarily be in a position to demand that the associate should maintain a set of records according to the investor's local GAAP. Consequently, the investor may have to resort to performing top-side adjustments to create the opening balance sheet and to maintain a post-acquisition balance sheet in order to calculate its share of the associate's net income, etc.
- Insurers may invest in investment funds that are to be accounted for under the equity method. Even though acquired at fair value, the issues are more concerned with the post-acquisition data management which can be complicated if, for example, available-for-sale (AFS) designation is used for debt and equity securities held in the fund (see Chapter Three).
- Insurers may invest in partnership structures which commonly trigger equity method accounting in the absence of control.
- There are other complexities involved if the investment is achieved in stages, given that there is limited guidance provided in IAS 28 and IFRS 3, and certain differences could exist with US GAAP.

1 Associates may be also referred to as affiliates or equity method investees. Concerning what constitutes a 'significant influence', IAS 28 'Investment in Associates' (IAS 28) paragraph 2 refers to the power to participate in the operating and financial policies of the entity and is generally viewed to be similar to the principle found in US GAAP under APB 18 'Equity Method of Accounting for Investments' (US APB 18). The presumption for the existence of significant influence can be found in IAS 28 paragraph 6 and US APB 18 paragraph 17.

2 Recognition of intangible assets and goodwill from an investment in an associate is addressed in IAS 28 paragraph 23 and US APB 18 paragraph 19.

1.5 Combinations involving mutuals

A mutual entity is defined as a non-investor-owned entity. Typically, the economic benefits of the operations are attributed directly to the owners, members or participants of the mutual entity and possibly through proportional allocation. Examples of mutual entities include mutual insurers and mutual co-operatives.

Business combination accounting, however, is based on control, which presumes a parent-subsidiary relationship. Combination arrangements between two or more mutual entities are generally entered into through legal statute, contractual arrangement, or related party activities with common services from a social, commercial, and financial perspective.

The differences in ownership structures between mutual entities and investor-owned entities create complications in business combination accounting. Consequently, IFRS 3 currently excludes from its scope combinations involving two or more mutual entities.[1] However, in the absence of guidance provided in either a Standard or an Interpretation, reference can be made to the use of alternative acceptable methods as long as they meet the requirements of IAS 8.[2] One particular method that could be applied is the approach currently used under US GAAP.

Under US GAAP, business combinations between two or more mutual enterprises are in the scope of US FAS 141, however, the effective date of US FAS 141 has been deferred for mutual entities until further guidance is issued.[3] In this case, the former US GAAP guidance for business combinations under APB Opinion 16 is applied, which permits the use of the pooling of interests method.

The question of whether the US GAAP methodology can be applied under IFRS in the absence of relevant IFRS guidance by virtue of IAS 8 is a matter of current debate.

Please note that the accounting for combinations involving mutuals is evolving. In the context of the IASB-FASB joint project on 'Business Combinations: Applying the Acquisition Method', both Boards have affirmed proposals that combinations between mutual entities (as well as business combinations achieved by contract alone, which may occur between mutual entities) should be in the scope of the final Statement on business combinations (referred to as IFRS 3R and FAS 141R). Consequently when these final standards are issued and effective, these transactions will be accounted for by applying the acquisition method under both IFRS and US GAAP. This is further discussed in the Epilogue.

1 IFRS 3 paragraph 3.

2 IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors' (IAS 8) requires the application of the IFRS hierarchy to develop accounting policies for that transaction. If there are no IFRS for similar transactions that can be used to develop these accounting policies, then IAS 8 permits an entity to apply an accounting policy from the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards (IAS 8 paragraph 21).

3 US FAS 141 paragraph 60 and reference to the FASB Project Update concerning 'Combinations between mutual entities' found on the FASB website (see http://www.fasb.org/project/mutuals.html).

1.6 PPA-related disclosure requirements

The types of disclosures associated with business combinations are highlighted below.

Disclosures concerning the deal itself:

The financial statement disclosure requirements concerning business combinations include, but are not limited to, the following:[1]

- the rationale for the deal;
- a description of the factors contributing to a purchase price that resulted in goodwill;
- the opening balance sheet grouped by major class of asset acquired and liability assumed and, in addition for IFRS reporting entities, disclosure of the carrying amounts reported in the acquired entity's balance sheet immediately before the combination in accordance with IFRS (unless impracticable);
- the amounts assigned to the major classes of intangible assets acquired (IFRS) or major categories of assets and liabilities (US GAAP), with further information concerning (i) finite-life intangible assets, including the useful lives, the amortisation method and amortisation rate, and (ii) indefinite-life intangible assets, including the reasons for assigning an indefinite life. US GAAP goes a step further by requiring disclosure of amortisation expense for each of the five succeeding years; and
- a statement as to whether the PPA is complete and if not complete the reasons why: in subsequent periods, any adjustments to the provisional figures must be shown.

Two illustrative examples of disclosure for a business combination transaction are provided in Section 1.6.1 below.

Disclosures specific to the VBI asset:

The PPA involving an insurer may include additional disclosures specific to a VBI asset recognised (a fair value adjustment to the contract liability discussed in Section 2.2.2.2). The disclosure requirements are found in IAS 38 and US EITF 92-9. The US GAAP disclosures include certain additional information such as, estimated amount or percentage of the end-of-the-year balance to be amortised during each of the next five years, which is not required for IFRS (see Section 1.7). For an illustrative example see Section 3.2.2.2.

Disclosures specific to the impairment of assets:

Both IFRS and US GAAP require disclosures concerning impairment charges related to goodwill and intangible assets, if applicable. Impairment charges are not a point of focus in this document, but reference can be made to IAS 36 and US FAS 142 for further information.

1 Disclosure requirements concerning business combinations including acquired intangible assets: Under IFRS, disclosure can be found in IFRS 3 paragraphs 66–77 and IAS 38 paragraphs 118–128. Under US GAAP, disclosures can be found in US FAS 141 paragraphs 51–57. Differences and similarities in disclosures can be found in PwC publication 'Similarities and Differences – A comparison of IFRS and US GAAP' (October 2007).

Disclosures concerning significant judgements and sources of estimation uncertainties:

Depending on the significance of the acquired intangible assets and goodwill recognised in the balance sheet, management may need to consider whether disclosure concerning significant judgements and/or key sources of estimation uncertainty (also referred to as critical accounting policies or estimates) should be given in the financial statement disclosures (IFRS) or in the MD&A disclosure (US SEC reporting purposes).[1] The level of disclosure can vary and could possibly include significant judgements and/or assumptions used in the valuation of acquired intangible assets and/or acquired in-force contracts, the determination of amortisation patterns and useful lives for finite-life intangible assets, and the determination of US GAAP fair values/IFRS recoverable amounts used to test goodwill and indefinite-life intangible assets for impairment on an annual basis. Some illustrative examples are provided in Section 1.6.2 below.

IFRS-US GAAP differences in disclosure are also highlighted in Section 1.7.

IFRS and US GAAP require qualitative and quantitative disclosure about the business combination. The disclosure requirements put the PPA in the spotlight for readers, analysts and the capital markets regulators by revealing whether the deal matched up to management's external communications at the time the M&A transaction was announced.

Two common points raised by regulators when reviewing the disclosures have been: (i) did the entity comply with the disclosure requirements, and (ii) is the disclosure consistent with what management communicated to the external marketplace at the time of the deal.

1 IFRS financial statement disclosure of significant judgements and estimates is found in IAS 1 paragraphs 113–124. US GAAP MD&A disclosure of critical accounting estimates is required by SEC registrants according to Section V 'Critical Accounting Estimates' in SEC Release No. FR-72 'Commission Guidance Regarding Management Discussion and Analysis('MD&A') of Financial Conditions and Results of Operation'.

1.6.1 Illustrative examples of disclosure on the transaction

Illustrative disclosure of a business combination transaction under US GAAP
Source: Metlife 2005 Consolidated Financial Statements (Life insurance)

2. Acquisitions and Dispositions

Travelers

On July 1, 2005, the Holding Company completed the acquisition of Travelers for $12.0 billion. The results of Travelers' operations were included in the Company's consolidated financial statements beginning July 1, 2005. As a result of the acquisition, management of the Company increased significantly the size and scale of the Company's core insurance and annuity products and expanded the Company's presence in both the retirement & savings domestic and international markets. The distribution agreements executed with Citigroup as part of the acquisition will provide the Company with one of the broadest distribution networks in the industry. Consideration paid by the Holding Company for the purchase consisted of approximately $10.9 billion in cash and 22,436,617 shares of the Holding Company's common stock with a market value of approximately $1.0 billion to Citigroup and approximately $100 million in other transaction costs. Consideration paid to Citigroup will be finalized subject to review of the June 30, 2005 financial statements of Travelers by both the Company and Citigroup and interpretation of the provisions of the acquisition agreement by both parties. In addition to cash on-hand, the purchase price was financed through the issuance of common stock as described above, debt securities as described in Note 8, common equity units as described in Note 9 and preferred shares as described in Note 14.

The acquisition is being accounted for using the purchase method of accounting, which requires that the assets and liabilities of Travelers be measured at their fair value as of July 1, 2005.

Purchase Price Allocation and Goodwill — Preliminary

The purchase price has been allocated to the assets acquired and liabilities assumed using management's best estimate of their fair values as of the acquisition date. The computation of the purchase price and the allocation of the purchase price to the net assets acquired based upon their respective fair values as of July 1, 2005, and the resulting goodwill, as revised, are presented below. During the fourth quarter of 2005, the Company revised the purchase price allocation as a result of reviews of Travelers underwriting criteria performed in order to refine the estimate of fair values of assumed future policy benefit liabilities. As a result of these reviews and actuarial analyses, and to be consistent with MetLife's reserving methodologies, the Company increased its estimate of fair value liabilities relating to a specific group of acquired life insurance policies. Consequently, the fair value of future policy benefits assumed, deferred tax assets acquired and goodwill increased by $360 million, $126 million and $234 million, respectively. The Company expects to complete its reviews and, if required, further refine its estimate of fair value of such liabilities by June 30, 2006. Additionally, the Company received updated information regarding the fair values of certain assets and liabilities such as its investments in other limited partnerships, mortgage loans, other assets and other liabilities resulting in a net increase of goodwill of $54 million. The fair value of certain other assets acquired and liabilities assumed, including goodwill, may also be adjusted during the allocation period due to finalization of the purchase price to be paid to Citigroup as noted previously, agreement between Citigroup and MetLife as to the tax basis purchase price to be allocated to the acquired subsidiaries, and receipt of information regarding the estimation of certain fair values. In no case will the adjustments extend beyond one year from the acquisition date.

	As of July 1, 2005 (In millions)	
Total purchase price		$11,966
Net assets acquired from Travelers	$9,412	
Adjustments to reflect assets acquired at fair value:		
Fixed maturities available-for-sale	(31)	
Mortgage and consumer loans	72	
Real estate and real estate joint ventures held-for-investment	17	
Real estate held-for-sale	22	
Other limited partnerships	51	
Other invested assets	201	
Premiums and other receivables	1,008	
Elimination of historical deferred policy acquisition costs	(3,210)	
Value of business acquired	3,780	
Value of distribution agreement acquired	645	
Value of customer relationships acquired	17	
Elimination of historical goodwill	(197)	
Net deferred income tax assets	2,098	
Other assets	(88)	
Adjustments to reflect liabilities assumed at fair value:		
Future policy benefits	(4,070)	
Policyholder account balances	(1,904)	
Other liabilities	(34)	
Net fair value of assets and liabilities assumed		7,789
Goodwill resulting from the acquisition		$ 4,177

Condensed Statement of Net Assets Acquired

The condensed statement of net assets acquired reflects the fair value of Travelers net assets as of July 1, 2005 as follows:

	As of July 1, 2005 (In millions)
Assets:	
Fixed maturities available-for-sale	$44,346
Trading securities	555
Equity securities available-for-sale	641
Mortgage and consumer loans	2,365
Policy loans	884
Real estate and real estate joint ventures held-for-investment	77
Real estate held-for-sale	49
Other limited partnership interests	1,124
Short-term investments	2,801
Other invested assets	1,686
Total investments	54,528
Cash and cash equivalents	844
Accrued investment income	539
Premiums and other receivables	4,886
Value of business acquired	3,780
Goodwill	4,177
Other intangible assets	662
Deferred tax assets	1,087
Other assets	737
Separate account assets	30,799
Total assets acquired	102,039
Liabilities:	
Future policy benefits	18,501
Policyholder account balances	36,633
Other policyholder funds	324
Short-term debt	25
Current income taxes payable	66
Other liabilities	3,725
Separate account liabilities	30,799
Total liabilities assumed	90,073
Net assets acquired	$11,966

Illustrative disclosure of a business combination transaction under IFRS
Source: Aviva 2006 Consolidated Financial Statements

(iv) AmerUs Group Co

On 15 November 2006, the Group acquired 100% of the common stock of AmerUs Group Co. (AmerUs) for US$69 in cash per common share of AmerUs. AmerUs is a leading provider of equity-indexed life and annuity products to the United States retirement and savings markets, and the acquisition establishes a leading presence for the Group in these selected high-growth segments.

The total purchase price of US$3.1 billion (£1.7 billion) represents cash consideration for AmerUs shares and stock options, and stock-based compensation vesting on change of control. The purchase consideration was partly financed by a £903 million placing of the Company's ordinary shares, with the balance of funding being provided by internal resources and external debt. The share placing was completed on 13 July 2006, with 129 million shares issued on 18 July, at £7 per share.

The issue of new shares in the Company has attracted merger relief under section 131 of the Companies Act 1985. Of the £903 million above, £32 million has been credited to share capital (see note 27) and £871 million has been credited to the merger reserve (see note 32(a)). Expenses of £11 million have been charged to the share premium account.

The AmerUs acquisition has given rise to goodwill on acquisition of £669 million, calculated as follows:

Purchase cost:

	£m
Cash paid	1,669
Attributable costs	11
Total consideration	1,680

The assets and liabilities at the date of acquisition were:

	Book value £m	Fair value and accounting policy £m	Fair value £m
Assets			
Acquired value of in-force business on insurance and investment contracts	179	1,387	1,566
Other intangible assets	126	165	291
Investments	11,539	5	11,544
Other assets	2,717	(1,270)	1,447
Total assets	14,561	287	14,848
Liabilities			
Gross insurance liabilities	11,055	(50)	11,005
Gross liability for investment contracts	1,137	5	1,142
Other liabilities	1,503	187	1,690
Total liabilities	13,695	142	13,837
Total net assets acquired	866	145	1,011
Goodwill arising on acquisition			669

The largest fair value adjustments above relate to the recognition of a value for the in-force business on insurance and investment contracts acquired by the Group (the AVIF) and to a reduction in Other assets. The AVIF adjustment of £1,387 million represents the excess of the value of the acquired in-force life insurance contracts over their IFRS net asset value, and is calculated as the difference between the acquired net tangible assets on a European Embedded (EEV) value basis and the same net assets on an IFRS basis. Deferred acquisition costs (DAC) totalling £1,297 million, included in Other assets in the book value column above, are not recognised in the IFRS fair value balance sheet as they have no fair value at acquisition. As DAC is reflected in the calculation of AVIF, its write-off in fair value adjustments is offset by the recognition of a fair value in AVIF.

Other intangible assets of £291 million are represented by AmerUs' distribution channels and have been valued by an independent third-party, using estimated post-tax cash flows and discount rates. The distribution channels have been assessed as having a life of between six and nine years and their value is being amortised over that period, with a corresponding release of the applicable deferred tax provision.

The residual goodwill of £669 million represents future synergies expected to arise in the combined life operations, the value of new business from new distribution channels and customers going forward, and the value of the workforce and management, related know-how and other future business value not included in the intangibles and the AVIF.

As disclosed in the supplementary information on page 231, the embedded value of the long-term business acquired was £1,107 million, representing the net assets acquired, adjusted for other intangible assets net of tax and corporate debt.

1.6.2 Illustrative examples of critical accounting estimates

US SEC Disclosure in MD&A for critical accounting estimates
Source: White Mountains Insurance Group 2006 annual report (Non-life)

4. Purchase Accounting

When White Mountains acquires another company, management must estimate the fair values of the assets and liabilities acquired, as prescribed by SFAS No. 141, "Business Combinations." Certain assets and liabilities require little judgment to estimate their fair values, particularly those that are quoted on a market exchange, such as publicly-traded investment securities. Other assets and liabilities, however, require a substantial amount of judgment to estimate their fair values. The most significant of these is the estimation required to fair value loss and LAE reserves. White Mountains estimates the fair value of loss and LAE reserves obtained in an acquisition following the principles contained within FASB Statement of Financial Accounting Concepts No. 7: "Using Cash Flow Information and Present Value in Accounting Measurements" ("CON 7"). Under CON 7, the fair value of a particular asset or liability essentially contains five elements: (1) an estimate of the future cash flows, (2) expectations about possible variations in the amount or timing of those cash flows; (3) the time value of money, represented by the risk-free rate of interest; (4) the price for bearing the uncertainty inherent in the asset or liability; and (5) other, sometimes unidentifiable, factors including illiquidity and market imperfections.

White Mountains' actuaries estimate the fair value of loss and LAE reserves obtained in an acquisition by taking the acquired company's recorded reserves and discounting them based on expected reserve payout patterns using the current risk-free rate of interest. Then, White Mountains' actuaries develop additional cash flow scenarios that use different payout and ultimate reserve assumptions deemed to be reasonably possible based upon the inherent uncertainties present in determining the amount and timing of payment of such reserves. In each scenario, the risk-free rate of interest is used to discount future cash flows. These scenarios are put in a statistical model that assigns a probability to each cash flow scenario. White Mountains' actuaries then choose the scenario that best represents the price for bearing the uncertainty inherent within the acquired company's recorded reserves. The "price" for bearing the uncertainty inherent within the acquired company's reserves is measured as the difference between the selected cash flow scenario and the expected cash flow scenario. The scenario selected has typically been between 1.5 and 2 standard deviations from the expected cash flow outcome. The fair value of the acquired company's loss and LAE reserves is determined to be the sum of the expected cash flow scenario (i.e., the acquired company's discounted loss and LAE reserves) and the uncertainty "price".

The difference between an acquired company's loss and LAE reserves and White Mountains' best estimate of the fair value of such reserves at the acquisition date is amortized ratably over the payout period of the acquired loss and LAE reserves. Historically, the fair value of an acquired company's loss and LAE reserves has been less than its nominal reserves at acquisition. Accordingly, the amortization has been and will continue to be recorded as an expense on White Mountains' income statement until fully amortized.

US SEC Disclosure in MD&A for critical accounting estimates
Source: Metlife 2006 annual report (Life)

Deferred Policy Acquisition Costs and Value of Business Acquired

The Company incurs significant costs in connection with acquiring new and renewal insurance business. The costs that vary with and relate to the production of new business are deferred as DAC. Such costs consist principally of commissions and agency and policy issue expenses. VOBA is an intangible asset that reflects the estimated fair value of in-force contracts in a life insurance company acquisition and represents the portion of the purchase price that is allocated to the value of the right to receive future cash flows from the business in-force at the acquisition date. VOBA is based on actuarially determined projections, by each block of business, of future policy and contract charges, premiums, mortality and morbidity, separate account performance, surrenders, operating expenses, investment returns and other factors. Actual experience on the purchased business may vary from these projections. The recovery of DAC and VOBA is dependent upon the future profitability of the related business. DAC and VOBA are aggregated in the financial statements for reporting purposes.

DAC for property and casualty insurance contracts, which is primarily composed of commissions and certain underwriting expenses, is amortized on a pro rata basis over the applicable contract term or reinsurance treaty.

DAC and VOBA on life insurance or investment-type contracts are amortized in proportion to gross premiums, gross margins or gross profits, depending on the type of contract as described below.

The Company amortizes DAC and VOBA related to non-participating and non-dividend-paying traditional contracts (term insurance, non-participating whole life insurance, non-medical health insurance, and traditional group life insurance) over the entire premium paying period in proportion to the present value of actual historic and expected future gross premiums. The present value of expected premiums is based upon the premium requirement of each policy and assumptions for mortality, morbidity, persistency, and investment returns at policy issuance, or policy acquisition, as it relates to VOBA, that include provisions for adverse deviation and are consistent with the assumptions used to calculate future policyholder benefit liabilities. These assumptions are not revised after policy issuance or acquisition unless the DAC or VOBA balance is deemed to be unrecoverable from future expected profits. Absent a premium deficiency, variability in amortization after policy issuance or acquisition is caused only by variability in premium volumes.

The Company amortizes DAC and VOBA related to participating, dividend-paying traditional contracts over the estimated lives of the contracts in proportion to actual and expected future gross margins. The amortization includes interest based on rates in effect at inception or acquisition of the contracts. The future gross margins are dependent principally on investment returns, policyholder dividend scales, mortality, persistency, expenses to administer the business, creditworthiness of reinsurance counterparties, and certain economic variables, such as inflation. For participating contracts (dividend paying traditional contracts within the closed block) future gross margins are also dependent upon changes in the policyholder dividend obligation. Of these factors, the Company anticipates that investment returns, expenses, persistency, and other factor changes and policyholder dividend scales are reasonably likely to impact significantly the rate of DAC and VOBA amortization. Each reporting period, the Company updates the estimated gross margins with the actual gross margins for that period. When the actual gross margins change from previously estimated gross margins, the cumulative DAC and VOBA amortization is re-estimated and adjusted by a cumulative charge or credit to current operations. When actual gross margins exceed those previously estimated, the DAC and VOBA amortization will increase, resulting in a current period charge to earnings. The opposite result occurs when the actual gross margins are below the previously estimated gross margins. Each reporting period, the Company also updates the actual amount of business in-force, which impacts expected future gross margins.

The Company amortizes DAC and VOBA related to fixed and variable universal life contracts and fixed and variable deferred annuity contracts over the estimated lives of the contracts in proportion to actual and expected future gross profits. The amortization includes interest based on rates in effect at inception or acquisition of the contracts. The amount of future gross profits is dependent principally upon returns in excess of the amounts credited to policyholders, mortality, persistency, interest crediting rates, expenses to administer the business, creditworthiness of reinsurance counterparties, the effect of any hedges used, and certain economic variables, such as inflation. Of these factors, the Company anticipates that investment returns, expenses, and persistency are reasonably likely to impact significantly the rate of DAC and VOBA amortization. Each reporting period, the Company updates the estimated gross profits with the actual gross profits for that period. When the actual gross profits change from previously estimated gross profits, the cumulative DAC and VOBA amortization is re-estimated and adjusted by a cumulative charge or credit to current operations. When actual gross profits exceed those previously estimated, the DAC and VOBA amortization will increase, resulting in a current period charge to earnings. The opposite result occurs when the actual gross profits are below the previously estimated gross profits. Each reporting period, the Company also updates the actual amount of business remaining in-force, which impacts expected future gross profits.

Separate account rates of return on variable universal life contracts and variable deferred annuity contracts affect in-force account balances on such contracts each reporting period. Returns that are higher than the Company's long-term expectation produce higher account balances, which increases the Company's future fee expectations and decreases future benefit payment expectations on

minimum death benefit guarantees, resulting in higher expected future gross profits. The opposite result occurs when returns are lower than the Company's long-term expectation. The Company's practice to determine the impact of gross profits resulting from returns on separate accounts assumes that long-term appreciation in equity markets is not changed by short-term market fluctuations, but is only changed when sustained interim deviations are expected. The Company monitors these changes and only changes the assumption when its long-term expectation changes. The effect of an increase/(decrease) by 100 basis points in the assumed future rate of return is reasonably likely to result in a decrease/(increase) in the DAC and VOBA balances of approximately $70 million for this factor.

The Company also reviews periodically other long-term assumptions underlying the projections of estimated gross margins and profits. These include investment returns, policyholder dividend scales, interest crediting rates, mortality, persistency, and expenses to administer business. Management annually updates assumptions used in the calculation of estimated gross margins and profits which may have significantly changed. If the update of assumptions causes expected future gross margins and profits to increase, DAC and VOBA amortization will decrease, resulting in a current period increase to earnings. The opposite result occurs when the assumption update causes expected future gross margins and profits to decrease.

Over the past two years, the Company's most significant assumption updates resulting in a change to expected future gross margins and profits and the amortization of DAC and VOBA have been updated due to revisions to expected future investment returns, expenses, in-force or persistency assumptions and policyholder dividends on contracts included within the Individual Business segment. The Company expects these assumptions to be the ones most reasonably likely to cause significant changes in the future. Changes in these assumptions can be offsetting and the Company is unable to predict their movement or offsetting impact over time.

The following chart illustrates the effect on DAC and VOBA within the Company's Individual segment of changing each of the respective assumptions during the years ended December 31, 2006 and 2005:

	Years Ended December 31,	
	2006	2005
	(In millions)	
Investment return	$192	$(26)
Expense	45	11
In-force/Persistency	(7)	(33)
Policyholder dividends and other	(39)	(11)
Total	$191	$(59)

As of December 31, 2006 and 2005, DAC and VOBA for the Individual segment were $14.0 billion and $13.5 billion, respectively, and for the total Company were $20.8 billion and $19.7 billion, respectively.

Goodwill

Goodwill is the excess of cost over the fair value of net assets acquired. The Company tests goodwill for impairment at least annually or more frequently if events or circumstances, such as adverse changes in the business climate, indicate that there may be justification for conducting an interim test.

Impairment testing is performed using the fair value approach, which requires the use of estimates and judgment, at the "reporting unit" level. A reporting unit is the operating segment or a business that is one level below the operating segment, if discrete financial information is prepared and regularly reviewed by management at that level. For purposes of goodwill impairment testing, goodwill within Corporate & Other is allocated to reporting units within the Company's business segments. If the carrying value of a reporting unit's goodwill exceeds its fair value, the excess is recognized as an impairment and recorded as a charge against net income. The fair values of the reporting units are determined using a market multiple, a discounted cash flow model, or a cost approach. The critical estimates necessary in determining fair value are projected earnings, comparative market multiples and the discount rate.

1.7 IFRS-US GAAP: Differences arising from the PPA and related matters

The IFRS-US GAAP differences highlighted below are in reference to existing IFRS-US GAAP differences in effect at 31 October 2007 and are subject to change as new/modified accounting standards and interpretations are issued by the IASB and/or FASB, such as the IASB-FASB joint project on Business Combinations Phase II, US FAS 157 'Fair Value Measurements' and the IASB's projects on Insurance Contracts Phase II which are highlighted in the Epilogue, along with other possible future changes.

Current IFRS-US GAAP differences concerning general accounting issues applicable for all business combinations are described in the PwC publication 'Similarities and Differences - A comparison of IFRS and US GAAP' (October 2007). Although the concepts underlying the PPA under IFRS and US GAAP are broadly similar, there are certain differences concerning insurers which are highlighted below.

- **Definition of a business:** Both IFRS and US GAAP business combination accounting is based on whether a business has been acquired. The IFRS definition of a business focuses on a set of integrated activities whereas the US GAAP definition is based on a set of integrated activities, that are 'self-sustaining'. Although the distinction may appear semantic, the IASB has acknowledged that differences could arise in certain circumstances.[1] See Section 1.1.2.
- **Acquired intangible assets and acquirer's intent to use:** Under IFRS an identifiable intangible asset is fair valued irrespective of the acquirer's plan to use or abandon the acquired asset based on a value that would be determined by a market participant.[2] However, under US GAAP the acquirer's intent may be considered in the present value technique. This can give rise to an IFRS-US GAAP difference in certain cases, see illustrative examples below and Section 2.1 concerning fair value measurement.

  Example 1 – Acquirer intends to use the acquired intangible asset over a period shorter than useful life: InsurGroup acquires Lifeco. InsurGroup has valued LifeCo's trademark at 1000 based on assumptions that would be used by a market participant. InsurGroup intends to use the trademark for one year and then abandon it. The value of that one year of use is 100. Under US GAAP the value of the intangible could be recorded at 100 and amortised over the one year the acquirer expects to use the trademark, or could be recorded at 1000 and amortised over one year. Under IFRS the intangible would be recorded at 1000 and amortised over the one year the acquirer expects to use the trademark.

  We believe that current US GAAP permits the use of buyer-specific assumptions. However, we also understand that the SEC may have a preference for the IFRS approach.

  Example 2 – Acquirer intends to abandon (not use) the acquired intangible asset: Under IFRS, a value would be assigned to the asset at the acquisition date based on what a market participant would pay. It would then be subject to an immediate impairment charge because it is not intended to be used and, therefore, will not generate future economic benefits to the acquirer. Under US GAAP, this is a developing area with two alternatives. If entity-specific assumptions are used, then no value is assigned to this intangible asset (fair value is zero). If market-specific assumptions are used, then the value would be amortised over its estimated useful life but there would rarely be an immediate charge. For example, if the brand name was purchased for the purpose of eliminating a competitor, the useful life would be the period of time over which increased sales would be realised as a result of the elimination of the competitor's brand. Impairment of the intangible would be assessed at the asset group level in accordance with US FAS 144.

1 IASB commentary on the definition of a 'business' under IFRS as compared to US GAAP is provided in IFRS 3 paragraphs BC12–15 and also described in the Glossary.
2 IAS 38 paragraph 40 based on an amount that the entity would have paid in an arm's length transaction.

- **Intangible asset recognition when the asset cannot be measured reliably:** Under IFRS, once it is determined that there is an identifiable intangible asset, then recognition of the asset is permitted only if it can be measured reliably:[1] Under US GAAP, the FASB has concluded that sufficient information should exist to measure reliably the fair value of that asset if an asset has an underlying contractual or legal basis, or if it is capable of being separated from the entity.[2]

  This type of difference could arise when valuing licences (see Section 2.3.3). However, we do not believe that IFRS-US GAAP 'differences in measurement' are sustainable.

- **Recognition and fair value measurement of investment contracts:** Under IFRS the fair value of the financial instrument should reflect, among other things, prepayment risk and surrender risk. The fair value should not be less than the present value of the surrender amount: in other words, the demand deposit floor.[3] The difference between the fair value and the recorded value of the financial liability is recorded as an intangible asset described in section 2.2.2.4. Under US GAAP, there is no demand deposit floor on fair value; therefore, the fair value could be recorded either as a net liability or a liability based on the account balance or US FAS 91 equivalent along with a separate VBI asset. Consequently, under both sets of standards, while an asset can be recognised, the classification and measurement of such asset can differ. The difference in measurement will depend on the significance of the surrender charges. Further guidance is provided under Section 2.2.2.4 for both unit-linked and non-linked investment contracts without discretionary participating features (DPF).
- **Negative goodwill:** The concept of 'negative goodwill' is similar under IFRS and US GAAP, as both require reassessment, however, the process and measurement differ. Under IFRS, in the event that there is an excess of fair value of net assets acquired over purchase price, the acquirer must reassess (i) the identification and measurement of the acquired entity's identifiable assets, liabilities and contingent liabilities, and (ii) the measurement of the acquisition cost. If it is determined on completion of the reassessment that these items were measured correctly, then the excess is recognised immediately in the income statement. Under US GAAP, the literature states that the excess is first allocated as a pro-rata reduction of the amounts assigned to all acquired assets except for (a) financial assets other than investments in associates, (b) assets held-for-sale, (c) deferred tax assets, (d) prepaid assets relating to pension and other post-retirement benefit plans, and (e) any other current assets. If any excess remains, after reducing to zero the other amounts that would otherwise have been assigned to those assets, that remaining excess is recognised as an extraordinary gain in the income statement[4]. In practice, acquired intangible assets are written down to zero followed by any other adjustments before recognising any remaining excess in the income statement.

  For a PPA involving insurers, care should be taken when reassessing assigned fair values under IFRS and US GAAP. Separate identifiable intangible assets such as renewal rights should be reassessed for a possible reduction in value as appropriate. However, we believe that this logic should not be applied to the VBI asset (see Section 2.2.2). In our view, the VBI asset should not be reduced in a 'negative goodwill' situation since any such reduction would result in adjusting the related net insurance contract liability away from its fair value. See Section 1.3.

1 General requirements specific to recognition of intangible assets is provided in IAS 38 paragraphs 21–23. Furthermore, IAS 38 indicates that in the context of a business combination, the 'probable' and 'measured reliably' criteria are, in general, presumed to be met unless the intangible is either not separable or it is separable but there is no history or evidence of exchange transactions for same or similar assets, in which case this would be subsumed within goodwill (IAS 38 paragraphs 33–38 and IFRS 3 paragraph 53).

2 The FASB were of the view that an intangible asset should be recognised if it meets the asset recognition criteria of FASB Concepts Statement 5 and if either there is control over the future economic benefits of the asset or the intangible asset is capable of being separated or divided with the general view that there should be sufficient information available to determine fair value (US FAS 141 paragraph B152).

3 The fair value of a financial liability with a demand feature is not less than the amount payable on demand, that is, a demand deposit floor (IAS 39 paragraph 49).

4 Treatment of negative goodwill: IFRS 3 paragraph 56 and US FAS 141 paragraphs 44–46 and B187.

- **Purchase accounting disclosures:** As described in general under Section 1.6.

  Opening balance sheet: IFRS disclosure includes the acquired entity's opening balance for each class of asset, liabilities, and contingent liabilities, both the fair values and carrying amounts immediately before the combination in accordance with IFRS. US GAAP disclosures only include a condensed balance sheet showing the amounts assigned to major categories of assets and liabilities of the acquired entity at acquisition date (ie fair values).[1]

  Intangible assets not recognised but subsumed in goodwill: These are assets that are not capable of being identified and separately recognised, or, specifically for IFRS cannot be measured reliably. IFRS requires a description of each intangible asset which was not recognised separately from goodwill, together with an explanation for the reasons why it could not be measured reliably.[2]

  Finite-life intangible assets and the VBI asset: US GAAP requires disclosure of aggregate amortisation expense for each of the five succeeding years[3], whereas IFRS does not specify this disclosure.

  Disclosure of goodwill tax deductibility: US FAS 141 requires disclosure of the amount of goodwill expected to be tax deductible[4], whereas IFRS does not specify this disclosure.

- **Push-down accounting:** This is an IFRS-SEC difference arising on the application of 'Push-down accounting' for entities that file financial statements with the US SEC. The US SEC has a specific rule that requires, in certain cases, the acquired entity's accounting records to reflect the fair value adjustments made to the assets and liabilities as reflected in the consolidation balance sheet in the acquirer's books (referred to by the US SEC as 'push-down accounting', see Section 2.5.5). It eliminates the need for the acquired entity to maintain two sets of records (one for local reporting and one for group reporting). Push-down accounting also includes goodwill that must be tested for impairment based on the subsidiary's own reporting units, which may be at a level lower than used for goodwill impairment testing performed for the consolidated financial statements. Consequently, this can result in additional impairment charges. There is no equivalent in IFRS.

- **Application of non-uniform accounting policies for group reporting:** The PPA is based on the assignment of fair values to the acquired net identifiable assets. Under US GAAP and under certain circumstances in IFRS, the insurer is permitted to present the fair value of contract liabilities under expanded presentation that splits the fair value into two principal components: a VBI asset and the recorded value of the liability (see Section 2.2.3). The recorded value will be based on the acquirer's group accounting policies relevant to the contract under US GAAP. Under IFRS the recorded value for contracts in the scope of IFRS 4 can be based on either the acquirer's group accounting policies or the acquired entity's existing accounting policies. Note: even if IFRS and US GAAP were similar in application of uniform accounting policies, the underlying valuation methods used for US GAAP and IFRS may differ. See Sections 2.2.2, 2.5.2 and Appendix I.

- **Amortisation of VBI-type asset and accounting for changes in amortisation patterns (insurance contracts and DPF investment contracts):** The basis by which the VBI asset is recognised and amortised may not necessarily be similar in IFRS and US GAAP because it depends on (i) contract classification, (ii) asset classification, and (iii) what the reference local GAAP was prior to the adoption of IFRS for such contracts. See Section 3.2.2.2.

1 Opening balance sheet disclosure: IFRS 3 paragraph 67(f) and US FAS 141 paragraph 51(g).
2 Opening balance sheet disclosure: IFRS 3 paragraph 67(h).
3 US FAS 142 paragraph 45(a)(3) and US EITF 92-9.
4 Goodwill tax deductibility: US FAS 141 paragraph 52(c)(1).

- **Impairment procedures for goodwill, acquired intangible assets and the VBI asset:** Certain differences may arise in the basis for conducting the valuations and the accounting thereof that are general in nature and, therefore, reference should be made to the PwC publication 'Similarities and Differences – A comparison of IFRS and US GAAP' (October 2007). The basis for determining and measuring impairment of a VBI asset can differ, especially for investment contracts that are not subject to prescribed loss recognition tests under US GAAP, resulting currently in diverse practice. See Section 3.4.

1 FPI = Foreign Private Issuers

Chapter two

Day One, the Purchase Price Allocation (PPA)

The purchase price allocation (PPA) is a four-step process.

1. All individual identifiable tangible assets and liabilities on the acquired entity's books are adjusted to fair value;
2. All acquired identifiable intangible assets and contingent liabilities that qualify for recognition are measured at fair value;
3. All necessary deferred tax adjustments arising from (1) and (2) above are recorded in the opening balance sheet; and
4. Goodwill is the difference between the cost of the business combination and the fair value of acquired identifiable net assets [the sum of (1) (2) (3) above].

This chapter explores the following topics concerning the PPA under IFRS and US GAAP.

Under business combination accounting, the PPA is the process of assigning fair values to the individual identifiable assets acquired and liabilities including contingent liabilities assumed at acquisition date. The PPA converts the acquired entity's pre-acquisition balance sheet from a balance sheet measured using the acquired entity's existing policies to a post-acquisition opening balance sheet based on fair values:

- the individual tangible assets and liabilities previously measured according to the acquired entity's accounting policies are measured at fair value determined at date of acquisition,
- contingent liabilities are recognised and measured at fair value, as required;
- non-current assets (or disposal groups) that qualify for 'held-for-sale' treatment are measured at fair value less estimated selling costs; and
- acquired intangible assets are recorded at fair value so long as they are identifiable and, for IFRS only, can be reliably measured (see Sections 1.2 and 1.7 for further information).

The PPA is required to be completed as soon as practical within a 12-month period from acquisition date. This is further discussed in Chapter Three.

The deal may be structured in such a way that the legal terms of the purchase agreement stipulate an allocation of purchase price to the various businesses acquired. Preparers of financial statements may feel that they are bound by the contractual constraint. It is important to understand the terms and conditions of the purchase agreement including any contractual allocation described and the reasons why such allocations were provided in the agreement. We believe that if the contractual terms differ from the economic substance of the transaction, then the substance should prevail as the purchase price allocation is based on assigning fair value to the individual identifiable assets acquired and liabilities and contingent liabilities assumed.

1 IFRS guidance found in IFRS 3 paragraphs 4, 36–37 and IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations' (IFRS 5). US GAAP guidance for long-lived assets acquired in a business combination is found in US FAS 144 paragraphs 34 and B85–B87.

2.1 The PPA is based on fair value, but what is fair value?

The FASB has issued Statement of Financial Accounting Standards No. 157 'Fair Value Measurements' (US FAS 157). US FAS 157 is effective in US GAAP for fiscal years beginning after 15 November 2007 for financial assets and financial liabilities, as well as for any other assets and liabilities that are carried at fair value on a recurring basis in the financial statements. At the time of writing, the FASB has proposed to provide a one-year deferral for the implementation of US FAS 157 for other non-financial assets and liabilities. This is further discussed in the Epilogue. The discussion below is based on current guidance in effect for fair value measurement under IFRS and pre-FAS 157 US GAAP.

IFRS and US GAAP in effect currently define fair value as the amount that would be used by market participants in a hypothetical arm's length transaction between a willing buyer and a willing seller. For which the best evidence is a quoted price in an active market.[1] In the absence of such data, consideration is given to the use of valuation techniques for which there are three generally accepted approaches, as presented below.

Approach	Comments
Market Approach	The Market Approach establishes the value of the asset (or liability) by comparison with prices achieved by similar assets (or similar liabilities). Matters to consider in evaluating comparability may include: type of contracts acquired or service provided, the market segment in which products and services are provided, the geographic area of operation, size, growth, historical and projected profitability, leverage, liquidity and diversification. The market price for the reference asset or liability will, in certain cases, be adjusted to reflect the features of the specific asset (liability) being measured that may not be factored into the market comparable if the two items are not identical. In certain cases and specific to certain insurance businesses, reference could be made to a recent transaction (eg transaction involving renewal rights or comparable block of business acquired or transferred and/or certain reinsurance pricing such as reinsurance stop loss for claims liabilities and quota share on unearned premium liability). However, the use of market comparables by insurers is not common, as such market activity is not frequent in occurrence.
Income Approach	The Income Approach estimates the future projected cash flows to be earned or saved by owning the asset (or to be paid on a contractual obligation) that are discounted back to present value. An option-pricing model may also be used in certain circumstances. This valuation may also include the estimated cost of capital required by a market participant associated with specific acquired in-force blocks of contracts, etc. (Section 2.2). The valuation may also include contributory asset charges for certain acquired intangible assets (see Section 2.3 and Glossary).
Cost Approach	The Cost Approach represents the cost of reconstructing or replacing a modern equivalent asset. In other words, the costs necessary to produce a replacement asset to substitute the asset in question. In general, this is used for tangible assets such as technology (software). It is not generally applicable to many acquired intangible assets because the cost of developing an intangible asset is often difficult to separate from the costs of developing the business. In addition, this approach is generally not applied for liabilities but may be observed in the valuation of prepaid services where cash is received for service upfront: valuation would consider the cost to perform plus a margin.

1 Current definition of fair value is provided in the Glossary.

... Some thoughts to take away concerning fair value measurement ...

- **US GAAP also considers buyer-specific assumptions in certain cases.** Fair value under IFRS and US GAAP is determined based on what a market participant would use in a market transaction. However, US GAAP also acknowledges the use of buyer-specific assumptions. If present value techniques are used, FASB has indicated that judgement is required in estimating the period and amount of expected cash flows. The estimated cash flows should be consistent with the objective of measuring fair value which should incorporate assumptions that marketplace participants would use in making estimates of fair value. The FASB staff have also indicated that the FASB did not intend to change practice with respect to the use of buyer-specific considerations that were applied in allocating the purchase price under the previous guidance in US APB 16. In developing fair value estimates, an acquiring entity's intended use (ie buyer-specific assumptions) may continue to be considered under US GAAP.[1] This is subject to change in future periods, in particular for US GAAP, because of US FAS 157. In the interim, this could give rise to IFRS-US GAAP differences (see Section 1.7 concerning valuation of intangible assets based on 'acquirer's intent to use').
- **Various methods could be used to determine fair value in the PPA exercise.** For the purposes of the PPA, the methods to determine the individual fair values of the acquired identifiable assets and liabilities assumed can range from (i) quoted market prices in active markets, (ii) external valuations such as independent appraisal valuations for real estate investment property and possible third-party valuations of certain acquired blocks of in-force insurance and/or investment contracts, and (iii) in-house valuation techniques, principally using the income approach, for the remaining assets acquired and liabilities assumed. Furthermore, we have observed that for the purposes of determining values for goodwill impairment testing, there may be a mix of both the Income approach such as embedded value, and market comparables, for example, multiples of new business (see Section 3.4).
- **In the context of a PPA, accountants and specialists need to work closely.** Co-ordinated input from accountants, valuation specialists and actuaries is recommended throughout the deal process. Specific to the PPA, it is essential that valuation and actuarial specialists are involved in identifying the acquired intangible assets, measuring and allocating the acquired cash flows across the acquired intangible assets and the acquired in-force contract liabilities, determining useful lives and amortisation profiles for finite-life intangibles assets. Depending on the complexities involved with tax, tax specialists may also be involved.

1 US FAS 141 paragraph B174.

The fair value measurement technique commonly used by the insurers is a discounted risk-adjusted cash flow technique under the Income Approach, principally for acquired insurance/investment contracts in-force and acquired intangible assets.

The general elements of the discounted cash flow technique are described below:

- **Projected estimated cash flows**, with assumptions based on current available information that a market participant would use, including the length of the cash flow projection period and any residual or terminal value at the end of the cash flow projection period.
- **The time value of money**, discounting the estimated projected cash flows to present value using the then-current risk-free interest rates[1] in the local market in which the business originates, if such cash flows include an adjustment for risk (as described below). For example, a risk-free rate used for valuing contracts issued in the US could be in reference to a spot-yield curve on US Treasuries or an implied yield on dollar-denominated swap contracts. However, if the estimated projected cash flows do not include an adjustment for risk, then the discount rate is adjusted for risk (the resulting rate is referred to as a risk-adjusted discount rate). Please note that for valuing certain life and savings participating contracts, expected investment return may also play an active part in the selection of the discount rate (see Section 2.2.2).

  For valuing intangible assets, valuation specialists do not use risk-free rates as a discount rate but rather the weighted average cost of capital ('WACC') by using a combination of the Capital Asset Pricing Model ('CAPM') for the cost of equity and by estimating the cost of debt. The rate for intangibles also typically includes a premium above the WACC given the additional risks involved in the realisation of value from intangible assets. In addition, in reconciling the discount rates being applied, a common test performed is a review of the implied discount rate for goodwill, which should be the highest rate given the risk profile around the realisation of value from goodwill.
- **An adjustment for risk**, to reflect the inherent risk in the liability or asset due to uncertainty in the timing and/or amount of the estimated cash flows, including liquidity and credit standing,[2] as appropriate. This risk adjustment can take the form of either a risk margin included in the estimated projected cash flows or an adjustment to the discount rate (ie, the risk-adjusted discount rate).
- **The cost of capital**,[3] representing the opportunity cost of having to hold additional capital over and above the fair value of the liabilities. Such capital is required to satisfy the insurance regulators and rating agencies to maintain the insurer's credit ratings. The cost is mainly driven by the difference between the return available on these restricted assets and the return required by the entity providing the capital. The evaluation should take account of a market assumption for cost of capital. This cost may be included in the adjustment for risk described above rather than being treated as a separate component of the discounted cash flows.

The discounted projected cash flow techniques can be based on a **deterministic approach** that uses a single set of best estimate assumptions. Alternatively it can be based on a **stochastic approach** that uses an average of the probability-weighted multiple cash flow scenarios allowing for all guarantees and embedded options, similar to a Monte Carlo simulation. For example, a deterministic approach would be an appropriate method for determining fair value if that is the approach that would be used by a market participant (eg, if there are no options and guarantee-type features in the acquired block of in-force contracts).

For further information specific to the valuation of acquired in-force contracts and acquired intangible assets specific to insurers, see Sections 2.2 and 2.3, respectively. More specifically, the basis for valuing acquired in-force non-life contracts and life contracts is described in Sections 2.2.1 and 2.2.2, respectively. These principles can also apply to health business, as appropriate, depending on the type of health business in question.[4]

1 The 'risk-free rate' is not a defined term and should be selected from market interest rates with the same characteristics of the cash flows such as, currency and duration.

2 For US GAAP, the consideration of credit standing in the context of fair value measurement may be diverse until US FAS 157 is effective.

3 The reference to 'cost of capital' in this publication refers to the required capital that an insurer must hold principally for insurance regulatory purposes. It is not in reference to the term 'cost of capital' that may be used outside of the insurance industry.

4 Health business can be classified as either life or non-life business it depends on the type of contract and the classification requirements of the local jurisdiction.

… Some comments concerning the discount rate …

- **Importance of the discount rate.** The choice of the discount rate should be carefully considered by management given its impact on the fair value measurement of insurance and investment contacts that will affect the residual amount of the purchase price attributed to goodwill. This consideration should include whether the discount rate is consistent with the current rates observed in the market in which the asset or liability originates. For example, it would not be appropriate to use a discount rate using the weighted average cost of capital (WACC) of the parent company based in Germany for valuing acquired insurance business in Japan.
- **Risk adjustment reflected in the discount rate.** When valuing assets the risk factor is added to the risk-free interest rate, resulting in a risk-adjusted rate that is higher than the risk-free rate (ie, reducing the value of the asset). When valuing liabilities, the risk factor is subtracted from the risk-free rate resulting in a risk-adjusted rate that is lower than the risk-free rate (ie, increasing the value of the liability).
- **Negative discount rates.** If the risk adjustment is included in the discount rate to measure the liabilities, then it is possible to have a negative discount rate. For example: if the risk-free rate is 3% and the liabilities being measured are subject to a high risk of variability in cash flows reflected by a risk premium of 7%, then in simplistic terms there is a negative risk-adjusted discount rate of -4%. In this case, the discounted liability would be higher than the undiscounted liability determined on a best estimate basis without risk adjustments. This circumstance could arise when valuing certain insurance contracts typically in jurisdictions that have relatively low interest rates.
- **Use of discount rates based on returns from assets backing the liabilities.** If recent transaction prices have used the return on assets backing the liabilities to determine the fair value, then it is a valid assumption to say that this return would be considered in the valuation that would be used by a market participant.
- **Consistent basis for determining the discount rates in the valuation.** In some circumstances, the discount rates applied by the actuaries to determine the fair value of insurance contract liabilities could be lower than the rates used by the valuation specialists to value intangible assets. One of the reasons for this difference is that there is less uncertainty in the estimated projected cash flows arising from in-force contracts than from expected future new business arising from the acquired intangible assets.

2.2 Fair value measurement of insurer's contractual obligations

Because of limited market data (other than data for financial variables) and a lack of uniform guidance for measuring the fair value of acquired in-force blocks of insurance and investment contracts, multiple valuation techniques have developed. These techniques range from simple methods based on expected future distributable earnings to more sophisticated methods incorporating embedded value concepts and other actuarial appraisal methods: the sophisticated approaches seek to measure the future economic benefits that will emerge on the acquired in-force contracts based on expected profit margins, risk and cost of capital based on required capital.

There are two broad methods that are used for determining the fair value of the acquired insurer's blocks of in-force contracts:

- **Direct Method:** The fair value of the contract liability is calculated by discounting the projected cash flows arising from all of the rights and obligations under the contract directly.
- **Indirect Method:** The fair value of the contract liability is determined indirectly by calculating the fair value adjustment, that is, the calculation of the present value of future profits to emerge on the acquired in-force block of contracts adjusted for risk, changes in required capital and income tax. The fair value adjustment normally reduces the liability's recorded value[1] to fair value (ie, a contra-liability). This fair value adjustment is typically based on contract liabilities measured according to insurance regulatory requirements (ie regulatory liability) that could differ from the recorded value determined for accounting purposes. In many jurisdictions, insurers present this fair value adjustment as a separate asset, a VBI asset or an equivalent (see Section 2.2.1 for non-life fair value adjustments, 2.2.2 for life business, 2.2.3 for 'Expanded Presentation' and 2.5.3 concerning certain income tax accounting considerations).

In general, it has been observed that the indirect method has been commonly used to fair value contracts written by life insurers whereas the direct method is more commonly used to fair value contracts written by non-life insurers. However, this is not always the case.

Because of the different methods and approaches currently used to measure the fair value of acquired blocks of in-force insurance and investment contracts, the basis on which similar structured acquisitions of insurance businesses are valued may differ.

Further commentary on fair value measurement of non-life and life contracts can be found in Sections 2.2.1 and 2.2.2, respectively.

1 The recorded value of the liability is determined in reference to the acquirer's group accounting policies for measuring that liability or, for IFRS only, the acquired entity's accounting policy could also be used (see Section 2.5.3 for further information).

2.2.1 Valuation issues concerning non-life contract liabilities

The information provided in this section is based on a non-life contract that transfers significant insurance risk from the policyholder to the insurer and qualifies for insurance contract accounting under IFRS and US GAAP. For general guidance on conditions required to qualify for insurance accounting under IFRS and/or US GAAP, please refer to general PwC guidance.

Concerning non-life contract liabilities, the principle elements to be addressed in the PPA (other than the recognition and measurement of acquired intangible assets addressed in Section 2.3) will include:

- Claims liabilities including claims incurred but not reported (IBNR) and claims settlement/handling costs are adjusted to fair value (see Section 2.2.1.1);
- Unearned premium liability is adjusted to fair value (see Section 2.2.1.2); and
- Deferred acquisition costs on the acquired in-force block of contracts are written off.

This is also highlighted in the tour of the acquired entity's balance sheet presented in Section 2.4.

2.2.1.1 Claims liability

The discounted cash flow technique described in Section 2.1 is used. As indicated in Section 2.2, the fair value of an acquired block of non-life in-force contracts is commonly determined using the direct method. The key components of this method are the expected undiscounted future cash payments, including estimated claims handling and settlement expenses, the expected timing of these payments (also known as the 'payment pattern'), and the discount rate.

The methods commonly observed are summarised below. The principle difference between the two methods is whether the risk adjustment is included as a margin in the estimated projected cash flows or as part of the discount rate. The resulting value should be consistent regardless of which method is used.

- **Expected cash payments including a risk margin and discounted using a risk-free discount rate:** The risk margin is included in the projected cash flows and can be determined using various methods including, but not limited to, loss development modelling, stochastic simulation, market values on recent reinsurance transactions, etc.
- **Expected value of cash payments discounted using a risk-adjusted discount rate:** The discount rate is derived from the risk-free rate and adjusted for the probability of the cash flows on the contract liability being higher than expected. For example, the risk-adjusted rate to be applied to an UK automobile insurance portfolio will be different from the risk-adjusted rate to be applied to a book of marine business written in the UK. The two risk-adjusted rates start with the risk-free rate commonly observed in the UK market at acquisition date, however, the additional risk adjustment factor will differ to take account of the different risks inherent in the portfolios being valued. In some cases, the risk-adjusted rate could be lower than the market investment yield and could be negative (as previously described in comment box on discount rates at the end of Section 2.1).

See Section 3.2.2.3 on amortisation of the fair value adjustment if presented separately from the recorded value under expanded presentation described in Section 2.2.3.

Illustrative example of discounting methodology applied on non-life liabilities under US GAAP
Source: St Paul Travelers, 2005 Annual Report and Form 10K

(7) An adjustment has been applied to SPC's claims and claim adjustment expense reserves and reinsurance recoverables at the acquisition date to estimate their fair value. The fair value adjustment of $191 million was based on management's estimate of nominal claim and claim expense reserves and reinsurance recoverables (after adjusting for conformity with the acquirer's accounting policy on discounting of workers' compensation reserves), expected payment patterns, the April 1, 2004 U.S. Treasury spot rate yield curve, a leverage ratio assumption (reserves to statutory surplus), and a cost of capital expressed as a spread over risk-free rates. The method used calculates a risk adjustment to a risk-free discounted reserve that will, if reserves run off as expected, produce results that yield the assumed cost-of-capital on the capital supporting the loss reserves. The fair value adjustment is reported as an intangible asset on the consolidated balance sheet, and the amounts measured in accordance with the acquirer's accounting policies for insurance contracts are reported as part of the claims and claim adjustment expense reserves and reinsurance recoverables. The intangible asset will be recognized into income over the expected payment pattern. Because the time value of money and the risk adjustment (cost of capital) components of the intangible asset run off at different rates, the amount recognized in income may be a net benefit in some periods and a net expense in other periods.

… Some thoughts on fair valuing non-life contracts …

Undiscounted cash flows concerning non-life contracts – There is a view that the undiscounted cash flows for the liability should usually be the acquired entity's recorded value just before the acquisition. Indeed this has been the general view held by the SEC in the past. Unless there was an error in the acquired entity's reserving bases in the pre-acquisition period, the best estimate of acquired entity should be the best estimate used by the acquirer for the acquired entity's block of non-life contracts on an undiscounted basis. We understand that the SEC has been concerned about increases in undiscounted cash flow liabilities made by acquirers only to be released in earnings in subsequent reporting periods. The acquired entity has the best information for establishing a best-estimate projection of cash flows with a presumption that, barring an error by the acquired entity, the amounts should be the same.

Risk margins – the use of risk margins (including risk margins reflected in the discount rate) should be based on what a market participant would use and may not necessarily be the basis by which accounting profits will emerge in future periods.

2.2.1.2 Unearned premium liability

The unearned premium liability is the portion of premiums that will be earned through income during the contract term subsequent to the reporting date, which in many cases may be for a period of less than one year.

The fair value of the unearned premium liability might be determined with reference to market observable data such as that observed in the proportional reinsurance market. This type of data may need to be adjusted to reflect the pricing of the risks at the acquisition date. 'Loss ratio time series'[1] could be used to determine the need for such adjustments. In the absence of that type of price information, a discounted cash flow technique could be used, that is, an indirect method where the fair value would be based on probability-weighted expected future claims, discounted at a market discount rate commensurate with the risk of variability in cash flows. There could also be a mark-up or mark-down adjustment linked to the pricing of the risks at a particular point in the underwriting cycle. In addition, loss-ratio benchmarks could be used to determine the presence of such adjustments.

Since most companies' insurance administration systems are designed to account for the gross unearned premium, the most practical way to account for the difference between the fair value and gross amount of unearned premium is often by means of an asset that is amortised pro rata over the remaining coverage period as premiums are earned. However, care should be taken for non-linear exposures, which should be amortised using the pattern that reflects the release from the underlying risk rather than on a linear basis. Again this will depend on the type of business written.

In certain cases, a proxy for fair value may be determined: either based on undiscounted unearned premium liability less a ceding commission a reinsurer would pay, or undiscounted unearned premium liability less any unamortised deferred acquisition cost. Either way, we believe that the acquirer should have evidence to support that the application of the 'proxy' method was in fact appropriate.

See Section 3.2.2.3 on amortisation of the fair value adjustment, if presented separately from the recorded value under the expanded presentation described in Section 2.2.3.

> The process used to determine the fair value of the unearned premium liability should not be underestimated as it can be significant, especially in respect of credit insurance and other warranty-type contracts.

1 'Loss ratio time series' is defined in the Glossary.

2.2.2 Valuation issues concerning life contract liabilities

2.2.2.1 General commentary

The information provided in Section 2.2.2 relates to contracts written by insurers that qualify for accounting as a life insurance contract or as an investment contract, depending on whether there is significant insurance risk and/or discretionary participating features (DPF).[1,2] Further information concerning how contract classification under US GAAP aligns with IFRS is provided in Appendix I and is summarised below.

- **Insurance contracts:** These are contracts that transfer significant insurance risk (ie, mortality or morbidity risk) from the policyholder to the insurer and qualify for insurance contract accounting under IFRS and US GAAP, as applicable. This category includes all life insurance contracts regardless of whether they are regular premium paying contracts, contracts that pay premiums over a period shorter than the contract term (referred to in the US market as 'limited pay' contracts), insurance contracts with DPF, and contracts whose premiums and certain other features are not fixed and guaranteed (referred to in some markets as 'universal life contracts'). These contracts are measured under IFRS using IFRS 4 (ie, 'local GAAP'),[3] and under US GAAP based on US FAS 97 for limited pay, US FAS 60 for non-participating contracts, either US FAS 60 or US FAS 120[4] for participating contracts, or US FAS 97 and US SOP 03-1 for universal life contracts.
- **Investment contracts with DPF:** Certain contracts that transfer no or insignificant insurance risk and also provide to the policyholders certain participating features. Because of the recognition and measurement requirements for investment contracts with DPF under IFRS, these are discussed separately in this document. These contracts are measured under IFRS using IFRS 4 and under US GAAP based on US FAS 97 and US SOP 03-1, or US FAS 91 in the absence of an account balance.
- **Investment contracts with no DPF:** Under both IFRS and US GAAP these contracts are measured as financial instruments as they have no or insignificant insurance risk. These contracts are measured under IAS 39 and are subject to a demand deposit floor,[5] which is not a concept under US GAAP. These contracts may be one of the following types:
  - **Unit-linked liabilities:** The investment returns and risks are borne principally by the policyholder. Under IFRS, these contracts are usually measured at fair value through the income statement in reference to the fair value of the assets backing the linked liabilities using deposit-method accounting under IAS 39. Under US GAAP, a similar approach applies only to unit-linked business that qualifies as 'separate accounts' with additional liabilities recognised for any minimum guarantee features according to US SOP 03-1; otherwise such contracts will be measured similar to 'non-linked liabilities' below.
  - **Non-linked liabilities:** The investment returns and risks are borne by the insurer that manages the assets according to its contractual obligations to the policyholders. Depending on the type of policy, these contracts may be measured in reference to an account balance, which under IFRS cannot be less than the surrender value. These contracts are accounted for under IFRS based on IAS 39 and under US GAAP based on US FAS 97 and US SOP 03-1, or US FAS 91 in the absence of an account balance.

Contract classification is not reassessed in the context of a qualifying business combination (see Section 2.5.1).

1 Discretionary participating features (DPF) is defined in the Glossary. It is a defined term in IFRS 4, however, it is not a term used under US GAAP.

2 In some cases, a US GAAP investment contract may be treated as an IFRS 4 insurance contract. See Appendix I.

3 IFRS 4 includes certain minimum requirements such as not allowing equalisation provisions, impairment testing for reinsurance assets, accounting for certain embedded derivatives, the application of unbundling under certain conditions, and a liability adequacy test (IFRS 4 paragraphs 14 and 15).

4 US FAS 120 makes reference to US SOP 95-1.

5 Under IFRS, fair value measurement can be not less than the amount payable on demand according to IAS 39 paragraphs 49 and AG82(g). In other words, it cannot be less than the present value of the surrender amount.

The fair value adjustment to the acquired block of in-force insurance and investment contracts, including any VBI asset is addressed in Section 2.2.2.2 (for insurance contracts), in Section 2.2.2.3 (concerning whether negative VBI is possible), and Section 2.2.2.4 (for investment contracts including unit-linked contracts). The recognition of acquired intangible assets on this business is described in Section 2.3.

This information is also highlighted in the tour of the acquired entity's balance sheet, see Section 2.4.

2.2.2.2 Life contracts with significant insurance risk

> It is not intended to describe in detail the methods used in determining fair value of life insurance contracts. It is important to work closely with the actuaries to understand what methodology is appropriate, what assumptions are to be established including the discount rate, and whether the resulting fair value would be an amount used by a willing buyer/seller in a hypothetical market transaction.

The determination of fair value for insurance contracts has been subject to considerable debate. Because of a limited market data, the discounted cash flow technique described in Section 2.1 is typically used. As indicated in Section 2.2, the fair value of an acquired block of life contracts is commonly determined using the **indirect method** based on the recorded value of the contract liability and a calculation of the VBI asset. However, some recent examples have been observed where the **direct method** has been used, although this is still in the early stages of development and yet to become common practice.

Commentary provided below is based on the **indirect method.**

The contract liability at recorded value:

The basis for determining the recorded value for the contract liabilities depends on the contract classification under IFRS and US GAAP.

- **IFRS:** IFRS 4 permits continued use of local GAAP subject to certain minimum requirements.[1] The local GAAP basis could be either the application of the acquirer's group accounting policy or the application of the acquired entity's accounting policy for the contract prior to acquisition (see Section 2.5.2 for application of non-uniform accounting policies).
- **US GAAP:** The accounting depends on the contract classification and the acquirer's group accounting policy: US FAS 60 for non-participating or participating contracts; US FAS 97 for limited pay contracts with premium paying period shorter than contract term, universal life contracts, and investment contracts; and US FAS 120 for participating contracts (if reporting group applies US FAS 120 rather than US FAS 60). Specific to US FAS 60 long-duration contracts measured using locked-in assumptions, the assumptions are reset and relocked based on current market data at acquisition date.

1 IFRS 4 includes certain minimum requirements such as not allowing equalisation provisions, impairment testing for reinsurance assets, accounting for certain embedded derivatives, the application of unbundling under certain conditions, and a liability adequacy test (IFRS 4 paragraphs 14 and 15).

Calculating the VBI asset:

Under the indirect method, the VBI asset is calculated based on the present value of future profits and adjusted for any difference in amount between the contract liability determined on a regulatory basis and its recorded value under IFRS/US GAAP, as appropriate. The most common approach for determining the VBI asset is based on the Actuarial Appraisal Method (AAM), also known as the Embedded Value Method, although details of its application vary in practice. The AAM consists of three components:[1]

1. Adjusted net asset value (ANAV):	Regulatory/statutory capital plus surplus, certain adjustments such as the allocation of surplus and non-admissible assets for regulatory purposes.	Embedded value*
2. Present value of in-force business:	Present value of distributable earnings (regulatory profit) discounted using a risk-adjusted rate**….a form of VBI asset.**	
3. Present value of future new business:	Forms part of acquired intangible assets, (ie customer relationships) or, subsumed in goodwill.	

** The Embedded Value is an element of the AAM value, being the sum of (1)+(2) above, although some individuals refer to (2) alone as the embedded value.*

So how is the present value of future distributable earnings on an acquired in-force block of contracts calculated? There are various approaches. Two illustrative examples are provided below, which are based on embedded value concept.[2]

- **Example 1: VBI asset based on the present value of distributable earnings including changes in capital.**

  For example: 1,000 of capital is injected into an insurance business on 1 January. A one-year policy is issued for a premium of 10,000 for which the regulatory liability and its recorded value is equal to 10,000. Assume that the business generated a regulatory insurance profit of 120 in the year. In addition, 30 (3% after-tax investment return) was earned on the 1,000 required capital. Total profit for the year is 150.

  If at the end of the year the required capital is zero (no policies remain), then the 1,150 can be distributed to the shareholders (being the return of capital of 1,000 plus the 150 total profit). If the risk-adjusted rate is 13%, then the present value of distributable profits at 1 January is 1,018 (1,150/(1+13%)). Therefore, if the business is acquired on 1 January, then 1,018 would be payable on that date to receive 1,150 at the end of the year.

  In this case, the fair value of the liability is 9,982 (being the regulatory liability of 10,000 plus the regulatory capital of 1,000 less the present value of the distributable earnings of 1,018). The VBI asset is 18, being the present value of the distributable earnings reduced for the required capital of 1,000. Note it would also be adjusted for any difference between the liability measured on a regulatory basis and the liability measured on an IFRS/ US GAAP basis (ie, recorded value), to arrive at the VBI asset for IFRS/US GAAP reporting purposes. However, in this example there was an assumption that these amounts were equal. Refer to Section 2.2.2.3 concerning negative VBI and Section 2.5.3 concerning income tax considerations.

  To reflect assumptions that market participants would use, investment yields used in the determination of future distributable earnings should assume that cash received in exchange for assuming the liabilities is invested in a portfolio of investments that are duration-matched with the liabilities. In many cases, the entity-specific market yield of current assets supporting the liabilities may be a reasonable proxy unless the investment mix is significantly different to how the average market participant might fund the liability.

  In calculating the fair value of the liabilities, all marginal costs relating to the block of business should be included. Overhead costs should, in theory, not be included because such costs do not relate to the in-force contracts being valued; however, they may be partially or fully included for practical reasons.

1 The complete AAM is only applicable for business combinations where the ANAV and the rights to future new business are exchanged. In reinsurance transactions and exchanges of blocks of business (eg, certain types of portfolio transfers), the first and third component of the AAM is usually not exchanged.

2 The data provided in the example are used to achieve the objective of demonstrating how fair value of the contract liability can be determined indirectly by calculating the VBI asset directly. It, however, does not reflect what may be realistically observed in valuing an acquired block of business in any particular jurisdiction.

- **Example 2: VBI based on the present value of regulatory profits less present value of cost of capital**

  This is an alternative method to get to the VBI asset of 18 described in Example 1 above. It takes the present value of regulatory profits of 106 (120/(1+13%)) less the present value of cost of capital of 88 (1,000*(13%-3%))/(1+13%). The 13% represents the risk-adjusted rate and the 3% represents the return on the locked-in capital: in other words, you need to earn 13% but the locked-in capital only earns 3%, which results in a cost of capital of 10%.

  In this case, the fair value of the liabilities is also 9,982 but is derived by subtracting the 18 from the regulatory liability of 10,000. This is just another way to look at it. Again, it would also need to be adjusted for any regulatory/GAAP liability difference to arrive at the VBI asset for IFRS/US GAAP reporting purposes.

An illustrative example of VBI asset disclosure is provided in Section 3.2.2.2

See Section 3.2.2.2 on amortisation of the VBI asset, if presented separately from the recorded value of the liability under expanded presentation described in Section 2.2.3.

... Some thoughts on valuing life contracts ...

- **Is the VBI an asset or an intangible asset?** VBI has generally been considered in industry to be an intangible asset. However, it is simply an amount that forms part of the fair value of a contract liability and, therefore, does not represent an intangible asset in itself.[1] In this publication we refer to this as a VBI asset separate from the acquired identifiable intangible assets. For IFRS, it is outside the scope of IAS 38 (except for disclosure, see Section 1.6) until the IASB completes its project on Insurance Contracts Phase II.
- **Is the VBI asset equal to present value of distributable earnings?** No. The VBI asset is, in fact, based on the present value of future distributable earnings adjusted for (i) costs of required capital, (ii) regulatory / GAAP liability differences, and (iii) a step-up adjustment for income tax.
- **Can the VBI be presented as a reduction of the contract liability (ie, a contra-liability)?** This is an alternative approach and avoids the theoretical question of whether the VBI meets the definition of an asset. This approach also solves the occasional problem when the fair value of a block of insurance liabilities exceeds its GAAP recorded value (see Section 2.2.2.3). Under this approach, the purchased contracts would be effectively accounted for in a manner similar to purchased debt, and new business would be accounted for according to the group's accounting policies for its contracts. The discount rate used for purchased liabilities would be established at the purchase date based on the estimate of the fair value of the liabilities in an unbiased exchange and the liability cash flows implicit in that valuation. Various methods for amortising the VBI may be considered and can depend on the contract in question such as (i) use of the effective interest method to amortise the discount or accrue a premium similar to a financial instrument with variable cash flows, or (ii) based on estimated gross profits.
- **Are there deferred tax implications?** The fair value of liabilities using the actuarial appraisal method is usually computed on an after-tax basis (see Section 2.5.3 which describes the deferred tax implications).
- **Are there specific measurement considerations for assets backing the insurance liabilities?** Various indirect fair value measurement models used currently for insurance contracts take account of the investment returns on assets backing policy liabilities. However specific to IFRS, the IASB's preliminary discussions ahead of Phase II of the IFRS Insurance Contracts project would suggest that the Board proposes that assets backing policyholder liabilities do not affect the best estimate of the value of the liability.

More commentary on the future implications of the IASB's Insurance Contract Phase II project on business combination accounting is highlighted in the Epilogue.

1 References to the VBI can be found in IFRS where the IASB has indicated that it does not consider the VBI asset to fulfil the requirements of IAS 38 (IFRS 4 paragraph BC 149). Under US GAAP references can be found to the VBI as an intangible asset under US EITF 92-9. However, it is generally not considered an intangible asset and therefore, not affected by US FAS 141 and US FAS 142.

Illustrative examples of valuation bases observed for the VBI asset (IFRS)

Source: AXA 2006 consolidated financial statements (acquisition of Winterthur)

Intangible assets totaling €3,468 million gross (€2,462 million net) were identified. They include:

– €2,327 million gross (€1,653 million net) relating to the value of purchased business inforce, consisting of the present value of future profits on contracts already inforce at the acquisition date. The present value of future profits takes into consideration the cost of capital and is estimated using actuarial assumptions based on projections made at purchase date but also using a discount rate that includes a risk premium;

Source: Aviva 2006 consolidated financial statements (acquisition of AmerUS)

The largest fair value adjustments above relate to the recognition of a value for the in-force business on insurance and investment contracts acquired by the Group (the AVIF) and to a reduction in Other assets. The AVIF adjustment of £1,387 million represents the excess of the value of the acquired in-force life insurance contracts over their IFRS net asset value, and is calculated as the difference between the acquired net tangible assets on a European Embedded (EEV) value basis and the same net assets on an IFRS basis. Deferred acquisition costs (DAC) totalling £1,297 million, included in Other assets in the book value column above, are not recognised in the IFRS fair value balance sheet as they have no fair value at acquisition. As DAC is reflected in the calculation of AVIF, its write-off in fair value adjustments is offset by the recognition of a fair value in AVIF.

Source: Old Mutual 2006 consolidated financial statements (general policy)

The present value of acquired in-force for insurance and investment contract business is capitalised in the consolidated balance sheet as an intangible asset.

The capitalised value is the present value of cash flows anticipated in the future from the relevant book of insurance and investment contract policies acquired. This is calculated by performing a cash flow projection of the associated long-term fund and book of in-force policies in order to estimate future after tax profits attributable to shareholders. The valuation is based on actuarial principles taking into account future premium income, mortality, disease and surrender probabilities, together with future costs and investment returns on the assets supporting the fund. These profits are discounted at a rate of return allowing for the risk of uncertainty of the future cash flows. The key assumptions impacting the valuation are discount rate, future investment returns and the rate at which policies discontinue.

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2.2.2.3 Is negative VBI possible on life insurance contracts?

A negative VBI is a liability in addition to the IFRS/US GAAP recorded value for the contract.

As fair value is determined using assumptions that market participants would use, entity-specific assumptions are not considered unless used as a proxy for market participant assumptions. Negative VBI could arise in circumstances where the recorded liability has been subject to more aggressive assumptions than those which would be used by a market participant (eg, the use of a higher interest rate assumption by the acquired entity that gives rise to a negative spread in the PPA).

The following are illustrative examples where a negative VBI could arise:

- **For an acquired entity that applied IFRS in the pre-acquisition period:** IFRS 4 has broad requirements for applying the IFRS 4 liability adequacy test (LAT). The LAT does not specify aggregation levels and, therefore, the aggregation levels used by the acquired entity in pre-acquisition periods could be broader than the levels used by the acquirer for the purpose of the PPA. In addition, the LAT does not require stochastic modelling across multiple scenarios that include all embedded options and guarantees, which can be considered in the VBI calculation by the acquirer.
- **For an acquired entity which applied US GAAP in the pre-acquisition period:** Specific to US FAS 97 annuity contracts, US FAS 97 neither permits the insurer to consider the payout annuity phase when measuring the deferred annuity contract liabilities (other than in the context of US SOP03-1) nor requires a loss recognition test for investment contracts.
- **Where the VBI asset is based on future distributable earnings and the regulatory liability value and the IFRS/US GAAP recorded value of the contract liability differ:** As indicated in Section 2.2, distributable earnings are based on regulatory-based values and, therefore, an adjustment needs to be made to the VBI for any difference between the recorded value (IFRS/US GAAP) and the regulatory liability that could result in a negative VBI.

  For example, the recorded value of the contract is 100 and the regulatory-based liability is 110. The calculation of the present value of future distributable profits provides a profit of 5. The fair value of the contract liability is 105 (being 110 less 5), but the recorded value of the contract liability is 100. As a result, a negative VBI of (5) is recorded to adjust the recorded value based on accounting policies to a fair value liability of 105.

As noted in Section 1.2, the VBI asset is permitted for insurance and investment contracts under US GAAP. Under IFRS a VBI asset is permitted for insurance contracts and, we believe, can also be applied to DPF investment contracts (as indicated in Section 2.2.2.4).

The VBI asset is not an asset per se but rather a fair value adjustment. It can be presented separately as an asset (if the fair value adjustment is positive) as an additional liability (if the fair value adjustment is negative, as in the example above).

2.2.2.4 Contracts with no or insignificant insurance risk (investment contracts)

The terms and conditions of investment contracts can vary across jurisdictions. Under IFRS and US GAAP, investment contracts have no or insignificant insurance risk. However, it should not be presumed that a US GAAP investment contract is always an IFRS investment contract or vice versa as there are differences – see Appendix I to the document.

The discussion below addresses the PPA implications depending on whether the investment contract is a unit-linked investment contract, a non-linked investment contract with no DPF, or a non-linked investment contract with DPF.

Unit-linked investment contracts

A predominant feature of unit-linked (variable-type) contracts is that the investment returns and most, if not all, of the investment risks are transferred to the policyholder.[1] The amount and timing of attribution to the policyholders is not at the discretion of the insurer. In addition, the insurer also delivers an investment management service to the policyholder. On acquisition, these contracts will be fair valued as noted below.

Deposit component: Fair value is determined by reference to the market value of the linked assets, however, under IFRS this amount cannot be less than the demand deposit floor.[2] Any financial guarantees will be included in this fair value: all floor guarantees such as guaranteed minimum benefits and other embedded derivatives should be recognised and measured in the contract liability.

Service component: The classification and measurement will depend on whether the reporting is conducted under IFRS or US GAAP.

- **Under IFRS, it could be considered a 'customer relationship':** It is an asset that is associated with the future profit margins to be earned in connection with services to be rendered under an investment management contract according to IAS 18, which is akin to an IAS 38 'customer relationship' (see Section 2.3).
- **Under US GAAP, it is considered a VBI asset:**[3] The asset would be calculated on a similar basis for measurement under IFRS, unless there are significant surrender charges (an illustrative example of this circumstance is provided under 'non-linked investment contracts' below).

The fair value under expanded presentation could result in IFRS-US GAAP presentational differences, see Section 1.7.

… Some thoughts on the intangible asset …

- **Asset recognition** – There could be a view that the asset for the service component is not recognised separately but instead forms part of the fair value of the contract liability. Consequently, this would result in a carrying amount lower than the demand deposit floor. We are of the view that this asset represents a contractual right to provide investment management services to the policyholders over the remaining term of the investment management contract that is described under IAS 18. Therefore, it would appear that this asset meets the criteria for identification under IAS 38 and can be fair valued.
- **Valuation** – The valuation of the separate service component of the investment contract under IFRS should be measured at fair value under IAS 38.40 based on what market participants would pay to acquire it. It should not be confused with the guidance provided in IAS 39.AG82(h), which discusses inputs associated with the 'servicing cost' used for valuing financial instruments at fair value. We understand that there are various views concerning the basis for which fair value determination can be achieved including reference to embedded value, a market consistent EEV, and the possible application of a service margin concept similar to what is proposed in the IASB's Preliminary Views on Insurance Contracts Discussions Paper (ie. Phase II). Accountants should work closely with valuation and actuarial specialists to determine the approach to be used based on the facts and circumstances involved.

1 Not all the investment returns may be passed through to the policyholder, as a certain amount may be used to pay the insurer's charge to the policyholder for investment management services. Not all of the investment risks may be transferred to the policyholder, as there is a floor value of zero.

2 Under IFRS, fair value measurement takes into account surrender risk and at the same time the fair value of the financial liability can be no less than the demand deposit floor (IAS 39 paragraphs 49 and AG82(g)). There is no demand deposit floor under US GAAP.

3 US EITF 92-9.

Non-linked investment contracts without DPF

Many non-linked investment contracts are similar to a savings account. They include contracts such as guaranteed income contracts (GICs), period-certain payout annuities, guaranteed equity bonds (GEBs) and the like. They are typically single premium-paying contracts such that the full premium (including built-in profit margins) is received on day one by the insurer.

On acquisition, these contracts will be fair valued as follows:

- **IFRS:** The fair value should be determined based on a discounted cash flow method taking account of surrender risk (ie, policyholder behaviour).[1] The financial liability can be no lower than the minimum surrender value eg, account balance less estimated surrender charges.[2] Any difference between the fair value and the recorded value of the financial liability may be recognised as a **core deposit intangible asset**[3] (see Section 2.3).
- **US GAAP:** The common approach is to use an indirect method to determine fair value where a VBI asset is calculated. The principal components include (i) the account balance, or in its absence an amount calculated using the constant yield method according to US FAS 91, and (ii) a VBI asset,[4] which is presented separately using expanded presentation (see Section 2.2.3). However, we have observed an emerging practice to use a discounted cash flow approach based on current-market rates rather than the actual crediting rates.

If there are surrender charges the amounts determined under IFRS and US GAAP will differ. See illustrative example below.

Example: At acquisition date, the account balance is 100, the surrender value is 90 (ie, impact of surrender charges) and the fair value is 80.

	IFRS	US GAAP
Recorded value of liability	90 (surrender value)	100 (account balance)
Less: Asset	(10) Core Deposit Intangible	(20) VBI asset
Fair value	**80**	**80**

This IFRS-US GAAP difference is also highlighted in Section 1.7.

Investment contracts with DPF

These contracts are investment contracts under US GAAP, but under IFRS fall within the scope of IFRS 4 principally because of the DPF.

Under IFRS 4, the recognition and measurement of this contract is based on existing accounting policies until Phase II subject to certain minimum requirements, and also permits a separate VBI asset to be recognised on the acquired in-force contracts (see Section 2.2.2).

Under US GAAP, the contract is accounted for on a basis similar to a non-linked investment contract without DPF under the indirect method with a VBI asset (see 'Non-linked investment contracts without DPF' above).

The IFRS 4 guidance on the presentation of liabilities acquired in a business combination and portfolio transfer refers to 'insurance contracts' and not to DPF investment contracts. However, as the recognition and measurement of investment contacts with DPF (including the related DAC and VBI) are in the scope of IFRS 4, we believe that the presentation of acquired liabilities for investment contracts with DPF can be presented using the IFRS 4 'expanded presentation' permitted for insurance contracts.

1 Fair value technique under IAS 39 described in paragraph AG82.
2 The value cannot be no less than the amount payable on demand, a demand deposit floor (IAS 39 paragraph 49). IAS 39 guidance on use of fair valuation techniques is found in paragraphs AG 79 and AG 82. The guidance indicates that if a valuation technique is used, then the value should include surrender risk and should not be less than the present value of the surrender amount.
3 IAS 39 discusses the concept of core deposit intangible assets in the Implementation Guidance F.2.3.
4 US EITF 92-9.

2.2.3 Financial statement presentation

There are two methods used to present the fair value of the acquired insurance business in the balance sheet.

Method 1 – Use of 'expanded presentation'

The ledger account balances for the contractual liabilities measured according to accounting policies (the recorded value), the VBI asset (or the fair value adjustment for non-life contracts) and the deferred tax impacts are presented separately. This is commonly seen in the life sector, however, this approach can also be used by an entity in the non-life sector, see illustrative example provided below.

Illustrative US GAAP example of gross presentation concerning treatment of fair value adjustments on claims reserves
Source: St Paul Travelers, 2005 Annual Report and Form 10K

4. INTANGIBLE ASSETS AND GOODWILL

Intangible Assets

The following presents a summary of the Company's intangible assets by major asset class as of December 31, 2005 and 2004:

(At December 31 2005, in millions)	Gross Carrying Amount	Accumulated Amortization	Net
Intangibles subject to amortization			
Customer-related	$1,036	$403	$ 633
Marketing-related	20	17	3
Fair value adjustment on claims and claim adjustment expense reserves and reinsurance recoverables(1)	191	(70)	261
Total intangible assets subject to amortization	1,247	350	897
Intangible assets not subject to amortization			
Contract-based	20	—	20
Total intangible assets not subject to amortization	20	—	20
Total intangible assets	$1,267	$350	$ 917

(At December 31 2004, in millions)	Gross Carrying Amount	Accumulated Amortization	Net
Intangibles subject to amortization			
Customer-related	$1,032	$252	$ 780
Marketing-related	20	7	13
Fair value adjustment on claims and claim adjustment expense reserves and reinsurance recoverables(1)	191	(58)	249
Total intangible assets subject to amortization	1,243	201	1,042
Intangible assets not subject to amortization			
Contract-based	20	—	20
Total intangible assets not subject to amortization	20	—	20
Total intangible assets	$1,263	$201	$1,062

(1) The time value of money and the risk margin (cost of capital) components of the intangible asset runoff at different rates, and as such, the amount recognized in income may be a net benefit in some periods and a net expense in other periods. See note 2 for further information on the fair value adjustment on claims and claim adjustment expense reserves and reinsurance recoverables.

Method 2 – Presentation of the liability at fair value

The ledger account balances (as described under Method 1 above) are added together and presented as one net amount. This is more commonly seen in the non-life sector (see illustrative example provided below).

Illustrative US GAAP example of presenting liabilities at fair value

Source: White Mountains Insurance Group Ltd 2005 Form 10K

Loss and loss adjustment expense reserve summary

The following table summarizes the loss and LAE reserve activities of White Mountains' insurance and reinsurance subsidiaries for the years ended December 31, 2005, 2004 and 2003:

	Year Ended December 31,		
Millions	**2005**	2004	2003
Gross beginning balance	**$ 9,398.5**	$ 7,728.2	$ 8,875.3
Less beginning reinsurance recoverable on unpaid losses	**(3,797.4)**	(3,473.8)	(4,071.9)
Net loss and LAE reserves	**5,601.1**	4,254.4	4,803.4
Loss and LAE reserves sold - NFU	**(95.9)**	–	–
Loss and LAE reserves sold - TPIC	**(11.8)**	–	–
Loss and LAE reserves acquired - Sirius [1]	**–**	1,328.9	–
Loss and LAE reserves acquired - Sierra Insurance Group [1]	**–**	244.4	–
Loss and LAE reserves acquired - Tryg-Baltica [1]	**–**	136.8	–
Loss and LAE reserves consolidated - New Jersey Skylands Insurance Association	**–**	62.1	–
Loss and LAE reserves sold - Peninsula Insurance Company	**–**	(17.0)	–
Loss and LAE reserves transferred [2]	**–**	–	(5.0)
Losses and LAE incurred relating to:			
Current year losses	**2,697.1**	2,476.0	1,948.7
Prior year losses [3]	**161.1**	115.1	189.4
Total incurred losses and LAE	**2,858.2**	2,591.1	2,138.1
Accretion of fair value adjustment to net loss and LAE reserves	**36.9**	43.3	48.6
Foreign currency translation adjustment to net loss and LAE reserves	**(39.4)**	48.0	–
Loss and LAE paid relating to:			
Current year losses	**(848.7)**	(926.3)	(825.3)
Prior year losses	**(2,294.9)**	(2,164.6)	(1,905.4)
Total loss and LAE payments	**(3,143.6)**	(3,090.9)	(2,730.7)
Net ending balance	**5,205.5**	5,601.1	4,254.4
Plus ending reinsurance recoverable on unpaid losses	**5,025.7**	3,797.4	3,473.8
Gross ending balance	**$ 10,231.2**	$ 9,398.5	$ 7,728.2

(1) Reinsurance recoverables on unpaid losses acquired in the Sirius, Sierra Group and Tryg-Baltica acquisitions totalled $283.8 million, $162.5 million and $14.0 million, respectively.

(2) Represents retroactive loss reserves ceded to Imagine Re. See Note 4.

(3) During the year ended December 31, 2005, White Mountains Re recorded $22.8 million of unfavorable development on its workers compensation reserves, respectively, relating to its Sierra Insurance Group acquisition, which was offset dollar-for-dollar by a reduction in the principal amount of the adjustable note that White Mountains Re issued as part of the financing of that acquisition (See Note 6).

Fair value adjustment

In connection with purchase accounting for the acquisitions of OneBeacon and Sirius, White Mountains was required to adjust loss and LAE reserves and the related reinsurance recoverables to fair value on OneBeacon's and Sirius' acquired balance sheets. The net reduction to loss and LAE reserves is being recognized through an income statement charge ratably with and over the period the claims are settled. Accordingly, White Mountains recognized $36.9 million, $43.3 million and $48.6 million of such charges, recorded as loss and LAE during 2005, 2004 and 2003, respectively.

The fair values of OneBeacon's loss and LAE reserves and related reinsurance recoverables acquired on June 1, 2001 and Sirius' loss and LAE reserves and related reinsurance recoverables acquired on April 16, 2004 were based on the present value of their expected cash flows with consideration for the uncertainty inherent in both the timing of, and the ultimate amount of, future payments for losses and receipts of amounts recoverable from reinsurers. In estimating fair value, management adjusted the nominal loss reserves of OneBeacon (net of the effects of reinsurance obtained from the NICO Cover, as defined below and the GRC Cover, as defined on page F-26) and Sirius and discounted them to their present value using an applicable risk-free discount rate. The series of future cash flows related to such loss payments and reinsurance recoveries were developed using OneBeacon's and Sirius' historical loss data. The resulting discount was reduced by the "price" for bearing the uncertainty inherent in OneBeacon's and Sirius' net loss reserves in order to estimate fair value. This was approximately 11% and 12% of the present value of the expected underlying cash flows of the loss reserves and reinsurance recoverables of OneBeacon and Sirius, respectively, which is believed to be reflective of the cost OneBeacon and Sirius would incur if they had attempted to reinsure the full amount of its net loss and LAE reserves with a third party reinsurer.

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… Fair value of claims liabilities and potential impact on claims development …

Fair value presentation of claims liabilities could impact the claims development disclosures required in the financial statements (IFRS) or in the information provided outside the financial statements (US SEC Reporting under Guide 6 for US SEC registrants). When presenting claims liabilities at fair value, there are some points to address concerning the impact on the presentation of claims development:

- **Is acquired insurance business included in the claims development from a purchase forward date or some other basis?** The PwC Survey on Insurers' Accounts under IFRS in 2005[1] revealed wide divergence in practice. Some entities included acquired insurance business from the purchase forward date while other insurers integrated the claims liabilities of the acquired insurance business as if it has been always part of the group's portfolios. In our view, the table should incorporate the liabilities from acquisition date (ie purchase forward date). Under US SEC reporting, the purchase forward date is also applied.
- **If the balance sheet presentation of liabilities is at fair value under Method 2 above, then should claims development be performed based on fair values?** Under IFRS, there is no specific guidance other than the requirement to present such information both gross and net of reinsurance. We are of the view that the use of either fair value amounts or undiscounted amounts is acceptable. However, in the former case the subsequent payments will have to be compared against the amounts increased from the unwinding of the discount. This is not the approach that we would favour because it appears to be very laborious. In this regard, reference can be given to IFRS 4 IG, which provides an example of the claims development table where the discount has been reported at the bottom of the table, which would be a better approach for an insurer that has not used the expanded presentation to account for the acquired liabilities. Under US SEC reporting, we have observed that the claims development is presented generally on a gross undiscounted basis with the fair value adjustment treated as a reconciling item between the claims development and the balance sheet presentation.

1 PwC publication 'Reporting under the new regime: A survey of 2005 IFRS insurance annual reports'.

2.3 Acquired intangible assets in insurance business combinations

The section does not address the VBI asset, which actually forms part of the fair value measurement for the contract liability as discussed in Section 2.2.

IFRS and US GAAP require the recognition of all acquired intangible assets if identifiable (and for IFRS if it can also be measured reliably). Both sets of standards include the concept of an indefinite-life intangible asset. A finite-life intangible asset must have an amortisation pattern that reflects the expected usage or economic benefit: the straight-line method of amortisation must be used if the usage pattern cannot be reliably determined (discussed further in Section 3.2.2).

The extent to which acquired identifiable intangible assets are recognised in the PPA will depend on the nature and type of business acquired. Some points have been observed in recent transactions for which the PPA has been completed:

Buyer	Acquired company	Reporting currency	Cost of Investment (in billions)	Ratio to cost of investment			
				VBI asset	Other identifiable intangible assets	Goodwill	Total acquired intangibles
Aviva	AmerUS	GBP	1.7	93%	17%	40%	100%*
Generali	Toro	Euro	3.8	22%	–	45%	67%
AXA	Winterthur	Euro	7.9	30%	18%	35%	83%
Swiss Re	GE Insurance Solutions	CHF	10.8	11%	6%	14%	31%
Lincoln National	Jefferson-Pilot	USD	7.5	33%	10%	44%	87%
Old Mutual	Skandia	GBP	4.0		76%	28%	100%*
United Health	Pacifica	USD	8.8	–	11%	74%	85%
MetLife	Travelers Life & Annuity	USD	11.5	33%	6%	36%	75%
WellPoint, Inc	WellChoice, Inc.	USD	6.5	–	27%	53%	80%
Manulife	John Hancock Financial Services, Inc.	USD	14.0	–	15%	53%	68%

**The value is greater than 100% as a result of a negative value assigned to fair value of net assets at acquisition date*

Additional comments:

- The VBI asset (discussed in Section 2.2.2) continues to be a fairly important item recognised in a PPA involving life insurers;
- Acquired intangible assets have included distribution networks, indefinite-life brands (eg, Aviva recognition of RAC brand, Manulife's recognition of the John Hancock brand), finite-life brands (eg, Eureko recognition of Interpolis), customer-related intangibles especially for non-life business, value attributed to licences;
- Fund management contracts have also been recognised by some acquirers including indefinite-life intangibles (for example Manulife for John Hancock and AXA Financial for Mony); and
- Specific to business combinations involving health insurance companies, we have also observed the recognition of 'member lists' and 'healthcare physician and hospital networks'.

Illustrative examples of different intangibles identified other than VBI (IFRS)

Source: AXA 2006 Consolidated Financial Statements (acquisition of Winterthur)

Intangible assets totaling €3,468 million gross (€2,462 million net) were identified. They include:

– €2,327 million gross (€1,653 million net) relating to the value of purchased business inforce, consisting of the present value of future profits on contracts already inforce at the acquisition date. The present value of future profits takes into consideration the cost of capital and is estimated using actuarial assumptions based on projections made at purchase date but also using a discount rate that includes a risk premium;

– a customer relationships intangible, only recognized if it can be measured reliably. For both life and non-life activities, this value represents the value of future cash flows expected from renewals and the cross-selling of new products to customers known and identified at the time of the acquisition. The total life and non-life value of this customer relationships intangible recognized in the opening balance sheet was €1,141 million gross (€809 million net). In the Property & Casualty business, these projections include assumptions regarding claims, expenses and financial revenues. For Life & Savings, it is estimated on the basis of the new business value when the portion relating to customers with inforce policies can be identified, measured and recognized separately.

All of these future cash flows have been measured without distinguishing the marketing resources (distribution channels, brand, etc.) through which they are expected to be secured, in order to ensure consistency with insurance industry practices, particularly as regards VBI, and also to avoid the recognition of redundant intangible assets. This method of measuring intangible assets is consistent with the method used when assessing the appraisal value.

Source: Old Mutual 2006 Consolidated Financial Statements (acquisition of Skandia)

Separate intangible assets have been identified and valued at £3,036 million, using estimated post-tax cash flows and post-tax discount rates. These intangibles represent the value of the PVIF, the values of the Skandia distribution network, customer relationships in re spect of non-life businesses, and the Skandia brand. No other intangibles were identified which were capable of reliable measurement. A deferred tax liability of £500 million has been provided for in respect of these intangible assets, based on the tax rates applicable in the various t erritories, on the grounds that the assets have no tax base, thereby creating temporary differences on which deferred tax must be provided.

2.3.1 Indefinite-life intangible assets

An indefinite-life intangible asset does not have a foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. In other words, the asset is not constrained by a finite legal, regulatory, contractual, competitive, economic or other factor that limits its useful life.[1] Indefinite-life intangible assets do not create post-acquisition earnings dilution from amortisation expense. However, such assets are subject to an annual impairment test that could result in non-recurring impairment charges (discussed further in Section 3.4).

There is no clear-cut list of the types of intangible assets that have indefinite lives versus finite lives as it depends on the facts and circumstances specific to the acquired insurance business. As indicated in the introduction of Section 2.3, examples of indefinite-life intangible assets in some recent M&A insurance transactions have included brands and some fund management contracts specific to proprietary retail fund management.[2]

Illustrative US GAAP example specific to a life acquisition
Source: Manulife (Canadian life insurer) acquisition of John Hancock (US financial services group) in 2004

Note 5 □ Intangible Assets

The acquired intangible assets include the JHF brand name, distribution networks, fund management contracts, and contractual rights. Of the total intangible assets, a portion was identified as the value of intangible assets that have finite lives and wil be amortized over their estimated useful lives (generally between 20 to 30 years), in relation to the associated gross margins from the related businesses. Additions in 2005 are investments in fund management contracts with finite lives.

For the year ended December 31, 2005	Balance January 1, 2005	Additions	Amortization	Change in foreign exchange rates	Balance December 31, 2005
Indefinite life					
Brand	$ 725	$ –	$ –	$ (25)	$ 700
Fund management contracts	353	–	–	(11)	342
	$ 1,078	$ –	$ –	$ (36)	$ 1,042
Finite life					
Distribution networks	$ 557	$ –	$ (10)	$ (12)	$ 535
Other intangible assets	171	10	(16)	–	165
	$ 728	$ 10	$ (26)	$ (12)	$ 700
Total	$ 1,806	$ 10	$ (26)	$ (48)	$ 1,742

... Some thoughts to take away ...

The determination of whether an acquired identifiable intangible asset has an indefinite life as defined by IFRS and US GAAP is a matter of judgement. We have observed that this determination has, at times, triggered a question from one specific capital markets regulator (the SEC) concerning the basis on which the determination was made. Furthermore, both the FASB and IASB consider that indefinite-life intangible assets to be rare.

1 IFRS 3 paragraph 88 and US FAS 142 paragraph 11 with examples provided in paragraphs 161 through to 169.

2 Proprietary fund management contracts could be determined to have indefinite useful lives in certain situations because there is a significant contract in place between the manager and the fund, to manage a very large fund.

2.3.2 Finite-life intangible assets

Acquired identifiable intangible assets with finite lives are amortised over their estimated useful lives in relation to their economic benefits. If the precise length of time is not known, then the useful life is estimated. The expected useful life should not be greater than the life arising from the contractual or other legal right, but it may be shorter depending on the period over which the entity expects to use the asset. However, IFRS and US GAAP indicate that if the contractual or other legal rights include a renewal period (such as for certain insurance business), then the useful life of the intangible asset should include the renewal period(s) as long as there is evidence to support renewal by the entity without significant cost[1].

Further information concerning amortisation is provided in Section 3.2.2.

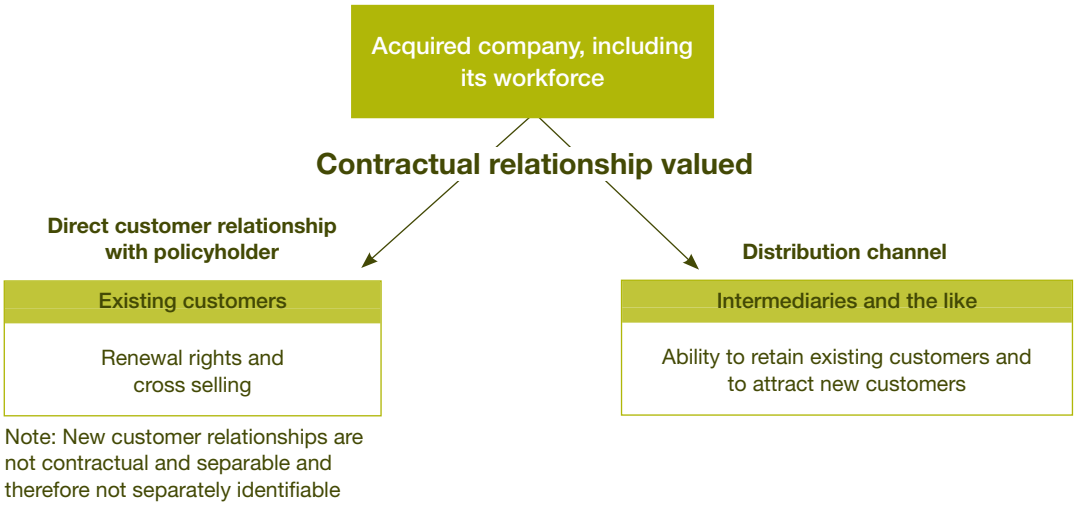
2.3.3 Intangible assets common in an acquired insurance business

The types of acquired intangible assets commonly seen in insurance business combinations are described in the tables on the following pages, which are intended to be used as a reference. The information is not meant to be exhaustive. The extent to which acquired intangible assets are recognised in the PPA will depend on the nature of the insurance business acquired, including the products and services offered.

A few important points concerning the tables:

- **Each of the identifiable acquired intangible assets listed in the tables may not necessarily be mutually exclusive of other intangible assets.** Some intangible assets involve overlapping cash flows, which can create difficulties in valuation.
- **There is no single acceptable method for measuring intangible assets at fair value.** Some observations on valuation methods commonly observed for each category of assets are provided in the tables.
- **Intangible assets for customer relationships can be the most difficult to identify and to measure.** An insurance business is a series of relationships that can be developed in different ways. It is crucial to understand what types of customer relationships were acquired. Insurers can have both direct customer relationships with the policyholder (referred to as 'direct customer relationships' in this document) or customer relationships established through a distribution channel where the acquired insurer's direct relationship is with the distributor and it is the distributor who has the direct relationship with the policyholder (referred to as 'distribution channel' in this document). These two types of customer relationships are mutually exclusive, but they can coexist in the same acquired insurance business depending on the nature of the acquired insurer's business. A direct customer relationship with a policyholder is less complex to identify because there is an identifiable link with the block of in-force contracts at acquisition date. However, the identification and measurement of a customer relationship based on a separate and contractual distribution relationship between the acquired insurer and a distributor can be more complex. As a general principle, if the ability to attract new customers lies within the acquired entity's workforce, then it is subsumed within goodwill under IFRS and US GAAP (ie, the case in a direct customer relationship). However, for a distribution channel where the value of the relationship is based on the output from the distributor, the fair value encompasses the distributor's ability to generate new business in addition to the existing business.

1 Amortisation period concerning renewal rights: IAS 38 paragraph 94 and US FAS 142 paragraph 11(d).



… Some thoughts to take away concerning 'customer relationships' …

Care should be taken when analysing customer relationships arising from distribution channels, especially when references such as 'agents' are used, as they could be employed representatives of the acquired entity and considered part of the workforce, or they could be independent agents that sell products across a portfolio of insurers. If the distributor operates on a sole-trading agreement with the insurer, it is referred to by some as a 'tied agent'. A tied agent only sells one insurance company's products (such as life assurance) rather than advising customers independently on all the products available from other providers. Usually insurers grant tied agents the right to be the only distributor in a particular area. A tied agent, may in some cases, be analogous to a workforce remunerated on a variable basis. For that reason its value is equivalent to the direct customer relationship. However, in circumstances where the agent is not legally treated as an employee (eg, for tax purposes and for accounting for share-based compensation), then treatment as a distribution channel may be more appropriate. Consideration must be given to the facts and circumstances involved.

It is also important to note that the issue of valuing customer relationship intangible assets has been subject to interpretation by the FASB Task Force under EITF No 02-17 'Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination'.[1] It has also become an annual topic of discussion by US SEC staff and, therefore, the basis for which it is recognised, measured and amortised should not be underestimated.

1 The conclusions reached in US EITF 02-17 concerning the recognition of acquired customer relationship intangible assets have also been incorporated into the new standards for business combinations, being Phase II of the IASB-FASB joint project effective in 2009 (see Epilogue).

Acquired intangible assets common in insurance business

The references to fair value measurement below are in the context of current accounting guidance in effect in October 2007. It does not take into account US FAS 157 'Fair Value Measurement' which will come into effect for fiscal years beginning after 15 November 2007 (i.e. 1 January 2008 for calendar year-end entities).

Type of Intangible Asset	Measurement
Customer relationships – direct customer relationships with policyholders *(This may be seen typically where the insurer manages its policyholders directly using an employed sales force or call centres and includes* renewal *rights and cross-selling opportunities)*	This asset represents the value of the expected future business from existing customer relationships, and can apply to both life and non-life business. Generally the fair value of an insurance customer relationship would be based on projected cash flows (eg distributable earnings) discounted at a market discount rate commensurate with the risk of variability in cash flows. Cash flows would be adjusted for the 'value of the contributory assets'[1] needed to service the customers. Valuation specialists are needed to identify the **net cash inflow** resulting from the relationship. **Renewal rights** can be a complex valuation area as they are based on customer behaviours that may be difficult to predict. It needs to be clearly distinct from other intangible assets recognised such as distribution channels. The valuation would consider the probability of contract renewals including forecasted premium volumes, premium rates, projected surrenders, proportion of business ceded to reinsurers, loss ratios and other expenses. Consideration may need to be given to the impact of reinsurance in the valuation that could produce different values depending on the type of reinsurance arrangement and whether the acquirer has the intention of continuing with the same programme or not. **Cross-selling** can be best described through an example. Insurer A (composite) acquires Insurer B (non-life entity). Insurer A intends to sell its ten life products to Insurer B's policyholders. This is a synergy subsumed within goodwill. However, if Insurer A knows that Insurer B currently has five products and each of Insurer B's customers has purchased on average two of the five products, then Insurer A would recognise the customer relationship that arises from the expected 'cross-selling' of Insurer B's five products. This can be represented by the expected increase of the average number of products that Insurer B's policyholders can have subsequent to the acquisition date. The challenge will be whether it can be measured reliably.
Customer relationships – distribution channels	The acquisition of a distribution channel can provide greater accessibility to a marketplace not previously tapped (for example, the acquired entity is an insurer that owns a bank distribution channel in a country where this is the primary source of distribution and the acquirer did not have a previous relationship with that distributor). Recognition depends on the answer to the question: 'How do policyholders renew business?'. If the insurer operates through distributors (eg, third-party brokers), then the distribution channel is valued based on existing customers and expected new customers. However, care should be taken to not doublecount the value attributed to existing customers in this intangible asset that may be already included in the expected future profits to emerge on acquired in-force contracts included in the measurement of the VBI asset. We have seen diversity in practice here. The value of these intangibles is typically determined by valuation specialists who consider discounted cash flows, or comparable market transactions. As an alternative to actuarial appraisal approaches, many specialists have determined the value of customer relationships attributable to distribution channels as a multiple of the value of new business emerging from distribution contracts in existence at the purchase date.
Customer lists/member lists	**Customer lists/members lists** consist of information about customers such as their name and contact information. Such assets are valuable in their own right as, subject to local legislation, they can be sold. Consideration could be given to comparable market transactions, or discounted cash flow analysis. **Member lists** may be seen more commonly with healthcare providers (eg, in the US).

1 'Contributory asset charges' is a term defined in the Glossary.

Type of Intangible Asset	Measurement
Brands, trade names and trademarks	Commonly seen with well-known household brand names. Recognition and measurement will depend on the business acquired and the brand recognition in the marketplace in which the acquired entity conducts business. It is generally valued under the Income approach (relief from royalty) based on market data for royalty rates, where available. This is often cross-checked against any market transactions (of brands) and the costs incurred if it is possible to isolate them.
Insurance licences	The licence arises from contractual or legal rights that could be required to operate in certain territories such as China, Japan or a state in the US, but is not separable (ie it can only be transferred as part of the sale of the business as a whole). The fair value of licences acquired would typically be established by reference to recent exchanges of so-called 'clean shells': insurance companies where existing in-force business has been novated so that the only remaining assets are certain invested assets and insurance licences. These clean shells are usually bought or sold for the fair value of their invested assets plus a stated amount per licence. This has been observed in the US marketplace (where state-by-state licences are needed). One approach is the Greenfield/build-out approach,[1] however, there are mixed views as to whether this approach gives a reliable measure sufficient for use under IFRS. This approach is most reliable when there is a competitive environment and far less so where there is little competition or a quasi monopoly. Whether this method is suitable will depend on the facts and circumstances of the situation. This type of approach should only be used in the absence of market data. It should include both direct costs of obtaining the licences as well as the opportunity cost associated with not being able to carry on operations during the licensing period.
Service contracts, provider contracts (health insurance) and outsourcing of costs (especially if not at market rates)	Favourable contracts could be estimated using discounted cash flows according to contractual rights and obligations and a discount rate commensurate with the risks attached to the cash flows.[2] For servicing contracts, this value should be reduced for contributory asset charges needed to service customers.[3] Both IFRS and US GAAP have special rules that should be considered.
Customer relationships – fund management contracts (asset management)	These are interdependent and are typically valued using the income approach based on the cash flows expected from existing customers.
Non-compete agreements	Non-compete agreements are generally valued under the income approach, by estimating the benefit from the non-compete agreements. They are not as common in the insurance sector, since a seller looking to get out of a line of business would typically agree to include a non-compete agreement and therefore the value of a transaction with or without the non-compete agreement would not be very different. It only includes assets that are part of the business acquired. Assets created on or post-acquisition are not included.
Computer software and internet domain names	Replacement cost approach and discounted cash flow approach (cost savings) are typically used.

1 Greenfield/build-out approach: Fair value is estimated based on a hypothetical entity that is valued on the basis that the entity has no other assets apart from the licence.

2 Unfavourable contracts would result in the recognition of a liability in the PPA for an onerous contract.

3 'Contributory asset charges' is a term defined in the Glossary.

Type of Intangible Asset	Measurement
Core deposit intangible asset	Recognised in the context of investment contracts without DPF under IFRS. This does not apply to investment contracts under US GAAP where a VBI asset is recognised (see Section 2.2.2.4). It represents the difference between the book value and fair value of the acquired deposit contracts. Core deposits typically (i) have rates paid that rarely change, even when market interest rates change, and (ii) remain in the balance sheet for long periods of time, despite changes in market interest rates. In other words, core deposits have (in many cases) interest expense behaviour patterns that are similar to those of long-term fixed-rate funding. The core deposit intangible asset represents the cost advantage of the core deposits.

… Measurement and the Tax Amortisation Benefit (TAB) …

The fair value measurement of acquired intangibles under an Income Approach (see Section 2.1) will reflect tax benefits associated with amortising the asset for income tax purposes. Under US GAAP, assets acquired in a business combination are assumed to receive a future tax deduction equivalent to the amount allocated in purchase accounting, so the fair value is 'grossed-up' for the benefits of future tax amortisation.[1] This approach has been applied consistently in US GAAP for many years. It is based on the idea that the fair value of the identifiable assets and liabilities should reflect the price that would be paid for the individual asset or liability outside the business combination – for example, if an asset was purchased separately, the buyer would usually obtain a tax deduction for the purchase price. US FAS 141 indicates that the amounts allocated in purchase accounting are the same irrespective of whether the combination is taxable or non-taxable. However, there is no equivalent guidance in IFRS 3 or IAS 38 and as a result there has been diversity in practice: some valuation experts have applied the US approach, some have never applied it because the benefits are not received, and some have applied it only for US reporting purposes. We believe that the fair value should be asset specific. In other words, a tax amortisation benefit should be included in the fair value of a specific asset if more than one hypothetical buyer could capture that tax benefit on day one (without buyer-specific synergies or tax attributes). A tax amortisation benefit should not be included in the fair value of an asset if that benefit would be available only to the acquirer or would not be available to any hypothetical buyers.

For entities reporting to the US SEC, the inclusion of the TAB is required (refer to US FAS 109). This matter has been recently highlighted by the US SEC indicating that some registrants have incorrectly excluded this adjustment from the valuation of acquired intangible assets.

1 This approach is derived from the combination of the following guidance. US FAS 141 paragraph 36 states that "the tax basis of an asset or liability shall not be a factor in determining its estimated fair value." This implies that the fair value of two individual assets should not be different because they have different tax bases. US FAS 109 paragraph 29 states that assets and liabilities acquired should not be stated net of any related deferred tax. The AICPA Practice Aid on research and development states that fair value should reflect the future income taxes that the acquirer would expect to pay, regardless of how the transaction is structured.

A few illustrative examples are provided below.

Example #1:

Reinsurer R acquires the motor insurance business unit of Insurer X (contracts in-force, underwriting and claims management teams, etc.). Insurer X has issued one-year non-cancellable motor insurance policies that are renewable by existing policyholders. Insurer X has evidence that a sizeable number of policyholders will renew their insurance contracts each year. In addition Insurer X has been reinsuring on a quota share basis 100% of its motor insurance business to Reinsurer R. Should the reinsurer recognize the customer relationship acquired as an intangible asset?

Answer: YES. Reinsurer R has acquired a business and it will identify the contractual customer relationships with the existing policyholders as part of its purchase price allocation. This customer relationship is an intangible asset that is recognised separately from goodwill provided its fair value can be measured reliably.

Example #2:

In the context of its 'in-sourcing' plans, Insurer G acquires Insurance Agency K, which, prior to the acquisition, intermediated 100% of Insurer G's motor insurance business in a particular region. Insurance Agency K operated under a delegated underwriting authority from Insurer G and delivered underwriting services to G policyholders. K also provided claims management services to Insurer G's policyholders under a separate service agreement with G. Should the insurer recognise the client relationship as an intangible asset?

Answer: NO. Insurer G has already acquired the customer relationships with its policyholders prior to the acquisition of the Insurance Agency K. The fact that Insurance Agency K is now part of the group will have increased the skills of the group's workforce but this is not an intangible asset that can be identified separately and its value will be part of the goodwill G will recognise from the acquisition of K.

The intangible assets associated with the contractual relationships with Agency K shall be recognised in Agency K's opening purchase balance sheet when fair valued. However, this intangible asset would be eliminated on consolidation by acquirer G as it is an inter-company transaction.

Example #3:

Entity K acquires 100% of a life insurance business in country X. The business acquired operates under a licence issued by the government to operate in that market. In country X an insurer cannot buy a licence separately from the business because the government has decided to limit the number of authorised life insurers and all licences had already been granted before Entity K completes its acquisition. Should the insurer recognise the license acquired as an intangible asset?

Answer: MAYBE. The licence arises from contractual or legal rights but is not separable (i.e. it could only be transferred as part of the sale of the business as a whole). The fact that it may not be reliably measurable could result in no recognition under IFRS, however, this may not necessarily be the case under US GAAP.

Example #4:

Star Insurance acquired 75% of a particular block of business of Poseidon Group (a part of Poseidon's entire group). Poseidon is a highly regarded conglomerate based in Cyprus. Under the purchase agreement Star Insurance will also have the right to use the 'Poseidon' brand on future insurance business to be sold in Cyprus for the next two decades. Should the insurer recognise the right to use the brand as an intangible asset?

Answer: YES. Star Insurance has only acquired a block of business. Star does not control Poseidon. However, Star has been given the right to use the Poseidon brand, which is both separable and contractual. The right to use the brand is an intangible asset.

NB: if Star acquired 75% of the entire business of Poseidon in which case Star controlled Poseidon Group, then it would recognise the brand asset without regard to the existence of a right.

Example #5:

Entity K acquires 100% of a life insurance business in Entity B, which paid US$1m to acquire an insurance company that has a non-life business and a licence to operate such business in country Y for the next 15 years. The licence can be acquired separately from the business. Should Entity K recognise the licence acquired as an intangible asset?

Answer: YES. The licence meets the definition of an intangible asset. This is a contractual intangible asset that is capable of being separated or divided from the entity.

Illustrative example of intangibles acquired in a non-life business combination
Source: St Paul Travelers, 2005 Annual Report and Form 10K

Identification and Valuation of Intangible Assets

Intangible assets subject to amortization (excluding the Nuveen Investments' intangible assets noted in item 8 of the allocation of the purchase price previously presented) were as follows:

(in millions)	Amount assigned as of April 1, 2004	Weighted-average amortization period
Major intangible asset class		
Customer-related(a)	**$495**	7.8 years
Marketing-related	**20**	2.0 years
Fair value adjustment on claims and claim adjustment expense reserves and reinsurance recoverables(b)	**191**	30.0 years
Total	**$706**	

(a) Primarily includes customer-related insurance intangibles based on rates derived from expected business retention and profitability levels.

(b) See item 7 of the allocation of the purchase price previously presented.

... Some thoughts to take away on acquired intangibles ...

Careful consideration should be given to the facts and circumstances relevant to each acquisition, including the process used to identify the acquired intangible assets and the basis for determining the valuation methods to be used and the assumptions to be used.

- ***Issues on identification.*** There are two major challenges associated with the identification of intangibles: (i) avoid using the same set of cash flows for more than one intangible asset, and (ii) do not overlook any material intangible asset, especially if it was part of the external communications made at the time of the deal.
- ***Issues concerning valuation.*** The valuation of intangible assets should be performed with all necessary parties involved, including (i) valuation specialists and actuaries for review of valuation methods applied, assumptions used, and general observations from the marketplace, (ii) management who will determine the valuation methods, set the assumptions, and who will provide the information necessary to support valuation assertions, (iii) accountants who will ensure that recognition and measurement is in accordance with financial reporting concepts for purchase accounting and (iv) auditors who will provide an audit opinion on the financial statements that include the financial output of those valuations. More specifically, valuation specialists and actuaries can assist the accountants in identifying the types of intangible assets that are possible and the challenges in recognising and measuring those assets in the opening balance sheet and the amortisation thereof in the post-acquisition period.

2.4 PPA tour of acquired insurer's balance sheet

The impact of the PPA on each balance sheet caption of the acquired business is presented in the following table, which applies to both IFRS and US GAAP unless otherwise indicated. The balance sheet captions are by order of increasing liquidity, a format generally observed in Europe.

The references to fair value measurement below are in the context of current accounting guidance in effect in October 2007. It does not take into account US FAS 157 'Fair Value Measurement' which will come into effect for fiscal years beginning afer 15 November 2007 (i.e. 1 January 2008 for calendar year-end entities). See Epilogue.

Balance sheet caption	Purchase accounting in the PPA
ASSETS	
Goodwill	The residual amount, representing the excess of purchase price over the fair value of identifiable intangible and tangible assets acquired and liabilities and contingent liabilities assumed.
Indefinite life acquired intangible assets	At fair value, typically determined through an appraisal based on comparable prices, and/or discounted cash flows, as appropriate in the circumstances. The cost approach is rarely used. The assets arise from contractual or legal rights or could be separately sold, transferred, licensed, rented or exchanged, either singly or in combination with a related contractual asset or liability. *For further information, refer to Section 2.3*
Finite life acquired intangible assets	At fair value, typically determined through an appraisal based on comparable prices, and/or discounted cash flows, as appropriate in the circumstances. The cost approach is rarely used. The assets arise from contractual or legal rights or could be separately sold, transferred, licensed, rented or exchanged, either singly or in combination with a related contractual asset or liability. *For further information, refer to Section 2.3*
Value of business in-force (VBI) *(under expanded presentation)*	Also referred to as PVFP, VOBA and VIF (see Glossary). This is the result of the expanded presentation. The VBI represents the difference between the recorded value and the fair value of the acquired in-force block of contracts gross of income tax considerations. Because the resulting VBI asset is in part dependent on the recorded value of the liability, which may be measured differently under IFRS and US GAAP, the VBI asset under IFRS and US GAAP could differ. Need to consider the facts and circumstances involved. *For further information, refer to Section 2.2.2*
Fair value adjustments on non-life undiscounted claims liability and unearned premium liability *(under expanded presentation)*	Arises if expanded presentation is used (i) liability stated at undiscounted amount and generally the recorded value in the acquired entity's books, and (ii) fair value adjustments recognised as an asset, being the difference between the fair value discounted risk-adjusted amount and the undiscounted recorded liability.
Debt investment securities *(quoted and unquoted)*	Fair value based on quoted market prices, quoted market prices of similar securities or cash flows discounted at current market interest rates appropriate for the credit standing of the issuer and the term of the security. For thinly traded or private placement securities, ensure that the fair values used are consistent with the practices of the acquirer in valuing similar securities and that the fair value used in purchase accounting is consistent with the fair value used by the acquirer for common holdings. **Important:** any existing cumulative unrealised gains and losses included in the revaluation reserves (OCI) for AFS securities is reset to zero, as part of resetting the equity balances to the purchase price.

Balance sheet caption	Purchase accounting in the PPA
Equity investment securities *(quoted and unquoted)*	Fair value based on quoted market prices or for securities without quoted market prices, estimates of fair value. Important: any existing cumulative unrealised gains and losses included in the revaluation reserves (OCI) for AFS securities is reset to zero, as part of resetting the equity balances to the purchase price.
Real-estate investments	Fair value, typically based on a real-estate appraisal of the fair value of the property at (or near) the purchase date.
Mortgage loans	Fair value based on the present value of expected cash flows discounted at interest rates appropriate for the credit standing of the borrower and the term of the loan that takes account of uncollectability[1]. The acquired entity's financial statement disclosures concerning fair value can sometimes be useful in determining fair values.
Policy loans	**IFRS:** Treated as a separate financial asset (gross) or as a prepayment of the insurance liability (net treatment). **US GAAP:** Fair value is generally based on present value of expected cash flows considering repayments and mortality, discounted at current interest rates. The fair value adjustment to the recorded amount may be presented separately or included as part of the fair value of the liability.
Other investments	Fair value based on the quoted market prices, quoted market prices of similar investments or discounted cash flows, as appropriate in the circumstances.
Property, plant and equipment used in the business (property for operating purposes including owner-occupied property)	Current replacement cost for similar assets based on fair value if a used-asset market exists; otherwise based on the cost of a new replacement asset less estimated accumulated depreciation. If expected future use indicates a lower value, that lower value should be used (US GAAP only).
Due and accrued investment income	Book value generally approximates fair value.
Deferred acquisition costs ('DAC')	Written off at acquisition date as fair value is zero.
Deferred origination costs ('DOC')	**IFRS:** The DOC balance relates to unit-linked contracts according to IAS 18. The DOC balance at acquisition date is subsumed in the fair value determination of the identifiable acquired intangible asset (ie, in the measurement of the customer relationship described in Section 2.2.2.4 under 'unit-linked investment contracts'). In the event that the intangible asset valuation is reduced to zero, then any additional liability is measured under IAS 37 as an onerous contract. **US GAAP:** Not applicable.
Receivables, including premiums receivable and receivables from reinsurers	Fair value based on the present values of amounts to be received which is determined at appropriate current interest rates and which takes account of difficulties with collection. However, the use of book value generally approximates present value for short-term receivables when the time value of money is not material.
Assets acquired and held-for-sale (held for disposal)	Fair value less costs of sale.

1 Valuation of mortgage loans consistent with requirements set out in AICPA SOP 03-3 paragraph.

Balance sheet caption	Purchase accounting in the PPA
LIABILITIES AND EQUITY	
Common and preferred stock	At par or stated value.
Additional paid in capital	Represents the excess of the purchase price over the aggregate par or stated value of common and preferred stocks.
Retained earnings	Zero in the opening PGAAP balance sheet.
Unrealised gains and losses on available-for-sale securities *(ie, OCI under US GAAP)*	Zero since the fair valuing of the related securities results in a new cost basis.
Long-term debt and borrowings	Fair value based on quoted market prices or cash flows discounted at current market interest rates appropriate for the credit standing of the issuer and the term of the security.
Pre-acquisition contingencies	Fair value, if determinable during the allocation period, otherwise, at management's best estimate if prior to the end of the allocation period information available indicates that it is probable that, as of the acquisition date, there is a liability and the amount can be reasonably estimated. *Example: litigation*
Defined benefit pension plan of a single employer	Liability for the projected benefit obligation in excess of plan assets or an asset for plan assets in excess of the projected benefit obligation. Consideration should be given to new assumptions. Projected benefit obligation calculations should consider expected terminations or curtailments, if any. Any existing unamortised transition obligations and unrecognised actuarial gains or losses would be eliminated in purchase accounting.
Defined post-retirement benefit plan of a single employer	Liability for the accumulated post-retirement benefit obligation in excess of the fair value of plan assets or an asset for the fair value of the plan assets in excess of the accumulated post-retirement benefit obligation. Any existing unamortised transition obligations and unrecognised actuarial gains or losses would be eliminated in purchase accounting.
Life insurance contract liabilities including insurance contracts with DPF[1] *(Significant mortality/ morbidity risk)*	The contract can be measured at fair value using one of two methods: using either a **direct method** to calculate the fair value of the contract or an **indirect method,** which is an approach commonly used in practice to determine the fair value indirectly by calculating a VBI asset with a liability stated at recorded value under IFRS/US GAAP. The fair value determined under IFRS and US GAAP should be consistent. However, when the indirect method and expanded presentation is used under IFRS and US GAAP, the recorded value of the liability measured under IFRS may not necessarily be the recorded liability measured under US GAAP. This depends on the 'local GAAP' used for IFRS 4 recognition and measurement. Need to consider the facts and circumstances involved. *For further information, see section 2.2.2.2.*

1 Insurance benefit liabilities are also referred to as technical provisions or future policy benefit reserves in many jurisdictions. These types of contracts may also include a liability for certain types of participating benefits.

Balance sheet caption	Purchase accounting in the PPA
Investment contracts with DPF *(No or insignificant insurance risk with certain participating features defined under IFRS 4)*	**IFRS:** The contract can be measured at fair value using one of two methods: using either a **direct method** to calculate the fair value of the contract or an **indirect method,** which is an approach commonly used in practice to determine the fair value indirectly by calculating a VBI asset with a liability stated at recorded value under IFRS/US GAAP. **US GAAP:** The common approach is to use an indirect method. The principal components include (i) the account balance, or in its absence an amount calculated using the constant yield method according to US FAS 91, and (ii) a VBI asset presented separately using expanded presentation (see Section 2.2.3). However, we have observed an emerging practice of using a discounted cash flow approach based on current-market rates rather than the actual crediting rates. There is no concept of a demand deposit floor under US GAAP. The fair value determined under IFRS and US GAAP should be consistent. However, when the indirect method and expanded presentation is used under IFRS and US GAAP, the recorded value of the liability measured under IFRS may not necessarily be the recorded liability measured under US GAAP. This depends on the 'local GAAP' used for IFRS 4 recognition and measurement. Need to consider the facts and circumstances involved. *For further information, see Section 2.2.2.4*
Unit-linked investment contracts. *(No or insignificant insurance risk with investment risk borne by policyholders with no DPF)*	**IFRS:** The contract has both a 'deposit component' and a 'servicing component' In measuring the deposit component, fair value is determined by reference to the market value of the linked assets, however, under IFRS this amount cannot be less than the demand deposit floor. Any financial guarantees will be included in this fair value: all floor guarantees such as guaranteed minimum benefits and other embedded derivatives should be recognised and measured in the contract liability. The service component will be recognised in reference to the investment management contract. **US GAAP:** The common approach is to use expanded presentation where the fair value is made up of a liability based on account balance and a VBI asset. There is no concept of a demand deposit floor. *Note that the IFRS separate presentation of the 'deposit component' and the 'service component' and the US GAAP VBI asset under expanded presentation result in an IFRS-US GAAP difference in asset classification and possible measurement differences if the surrender charges are significant.* *For further information, see Section 2.2.2.4*
Non-linked investment contracts without DPF	**IFRS:** The fair value should be determined based on a discounted cash flow method taking account of policyholder behaviour. Any difference between the fair value of the financial liability and its minimum surrender value may be recognised as a core deposit intangible asset. **US GAAP:** The common approach is to use an indirect method. The principal components include (i) the account balance, or in its absence an amount calculated using the constant yield method according to US FAS 91, and (ii) a VBI asset presented separately using expanded presentation (see Section 2.2.3). However, we have observed an emerging practice of using a discounted cash flow approach based on current-market rates rather than the actual crediting rates. There is no concept of a demand deposit floor under US GAAP. *Note that under IFRS the financial liability cannot be lower than the minimum surrender value. This is not a concept under US GAAP and, therefore, can result in a difference if using expanded presentation. The overall fair value should be consistent.* *For further information, see Section 2.2.2.4*

Balance sheet caption	Purchase accounting in the PPA
Deferred revenue liability	**IFRS:** This item would be subsumed in the fair value of the contract liability, or included in the valuation of the intangible asset except in the event that the intangible asset valuation is reduced to zero in which case it is presented as an additional liability measured under IAS 37 as an onerous contract.[1] **US GAAP:** Practice varies and will depend on the facts and circumstances involved. The future costs and charges should be implicitly included in the fair value. However, it could be presented as a separate liability adjusted to fair value that would be amortised over the period in which service is to be rendered. *For further information, see Section 2.2.2.4*
Non-life insurance claim liabilities including claims settlement costs	Principally for non-life business and certain health business. Fair value determined principally using the direct method (discounted projected risk-adjusted cash flows). Presented either as one amount being the fair value of contract liability, or under the 'expanded presentation' where the fair value adjustment is reported as an asset and the undiscounted amount represents the liability's recorded value. *For further information, refer to Section 2.2.1.*
Non-life insurance unearned premiums liabilities	Fair value determined principally using the indirect method (calculate the fair value adjustment), however, in certain cases a proxy may be used. Could be presented in balance sheet using expanded presentation or at fair value. *For further information, refer to Section 2.2.1.*
Deferred income taxes	Deferred taxes represent the difference between asset and liability tax and book bases relating to temporary timing differences, at enacted marginal tax rates.
Accounts and notes payable, and other claims payable; liabilities and accruals	Present values of amounts determined at appropriate current interest rates. However, the use of book value generally approximates present value for short-term payables when the time value of money is not material. *This can include accruals for vacation pay, and deferred compensation; other liabilities and commitments, such as unfavourable leases and contracts.*

... Some thoughts to take away ...

For each fair valuation adjustment made, an important question should be asked: 'Will this adjustment result in a deferred tax adjustment to be recorded?'. For further information see Section 2.5.3.

1 The IFRS guidance concerning deferred revenue liability expressed in the table represents our view. We also understand that there is a possible alternative view to recognise both the deferred revenue liability and DAC on investment contracts in a business combination, however, we do not believe that this is consistent with the requirements of IFRS 3 to fair value all assets acquired and liabilities assumed.

2.5 Other PPA considerations specific to insurers

2.5.1 Contract reassessment at transaction date

The accounting for insurance contracts under IFRS and US GAAP depends on the contract classification (see Section 2.2.1 and 2.2.2). The contract classification can also affect income statement presentation because premiums received and claims paid are accounted for using the deposit method for certain contracts.[1]

At acquisition date, the question is whether contract classification should be reassessed.

Under US GAAP and in the context of a business combination, contract classification is not reassessed at acquisition date because a business is acquired and the underlying parties and the terms and conditions of the underlying contract do not change.

Under IFRS 4, contract classification is determined at inception. Once the contract qualifies as an insurance contract it remains as an insurance contract until all rights and obligations are extinguished or expired. However, an investment contract can become an insurance contract at a later date because of a policyholder election to exercise an existing option that was part of the terms and conditions of the contract at inception. In this case, the exercise of the election changes the level of insurance risk such that it becomes significant.[2]

IFRS does not provide specific guidance concerning whether reassessment of contract classification is required in a qualifying business combination. However, we believe that according to the existing guidance in IFRS 4 contract classification is not reassessed at acquisition date for reasons similar to that described above for US GAAP.

Example: *LifeCo issued a 15-year contract in 2000 which has significant insurance risk in the first five years and no insurance risk in the last ten years. At contract inception, the 15-year contract was classified as insurance. In 2007, LifeCo was wholly acquired by Epargne Insurance and is now a subsidiary of Epargne Insurance. The rights and obligations under the existing contractual relationship are with LifeCo even if the insurance operations of LifeCo are acquired by Epargne Insurance. There is no change in the existing contractual relationship. At the acquisition date, the 15-year contract no longer bears insurance risk, however, it will remain classified as insurance in the consolidated financial statements of Epargne Insurance by virtue of IFRS 4.B30.*

Similarly, a contract that was classified as an investment contract at inception because of a lack of mortality risk will remain an investment contract unless there is a change upon election of an existing option that introduces significant insurance risk at a later date.

Contract reassessment associated with transactions that do not qualify as a business combination, such as certain portfolio transfers, is addressed in the commentary box in Section 1.1.2.

1 For US GAAP, deposit accounting is applied to US FAS 97 investment contract, and US FAS 97 universal life contracts. For IFRS, deposit accounting is applied to non-DPF investment contracts measured under IAS 39. The deposit method of accounting may also be applied for DPF investment contracts if it is the existing accounting policy used by the entity according to IFRS 4.

2 IFRS 4 paragraph B29 indicates that for contracts that do not transfer risk at inception, reclassification as an insurance contract can occur at a later date when the level of insurance risk changes (such as, investment contract that provides an option to purchase an annuity at market rates at annuitisation date that becomes an insurance contract when the option is exercised).

2.5.2 Use of non-uniform accounting policies for insurance contracts

Once an acquisition is completed, the activities of the acquired business are either consolidated as a subsidiary or accounted for under the equity method of accounting. In general, IFRS and US GAAP require the application of uniform accounting policies for like transactions and other events in similar circumstances in the preparation of consolidated financial statements.[1]

However, IFRS provides one exception specific to insurance contracts and investment contracts with DPF under IFRS 4. Under IFRS 4, non-uniform group accounting policies for insurance and investment contracts can continue to coexist in the same group if such diverse accounting policies existed prior to the adoption of IFRS[2]. However, an acquired entity cannot change its own existing policies if that creates more diversity.

Example: *INSURE plc has subsidiaries operating in France and in the UK. Prior to the adoption of IFRS and as permitted under national requirements for consolidated financial statements, INSURE plc's French subsidiary applied French GAAP for its French insurance contracts and its UK subsidiary applied UK GAAP for its UK insurance contracts. As permitted by IFRS 4, the existing non-uniform accounting practices can continue under IFRS.*

If, however, an insurer with non-uniform accounting policies acquires an insurance business with different accounting policies, then the introduction of those non-uniform accounting policies of the acquired entity would be permitted for contracts in IFRS 4 for the enlarged group for consolidation purposes: post-acquisition diversity in the group accounting policies arising from a business combination is permitted under IFRS.

Example: *Following on from the example above, subsequent to the adoption of IFRS INSURE plc acquires a business in Mexico that measures its insurance contracts using Mexican GAAP. Can INSURE plc permit the newly-acquired Mexican subsidiary to measure its insurance contracts using Mexican GAAP for consolidation purposes, or, must that acquired entity apply the group's existing policies of either UK GAAP or French GAAP? In our view, the acquired entity can continue to apply Mexican GAAP for IFRS reporting as it was an existing accounting practice used by the acquired entity prior to the acquisition. In conclusion, the accounting policy used is the local GAAP applicable to the jurisdiction in which the policy is issued (that is, following the acquisition of the Mexican insurance business, INSURE plc's accounting policy for measuring insurance contracts would be French GAAP for French insurance contracts, UK GAAP for UK insurance contracts and Mexican GAAP for Mexican insurance contracts).*

The permission to use non-uniform accounting policies applies only for IFRS reporting entities for measuring insurance contracts and DPF investment contracts under IFRS 4. There is no similar exemption provided in US GAAP. This can lead to IFRS-US GAAP differences in post-acquisition accounting (see Section 1.7).

1 The principle of application of uniform accounting policies by the parent company, subsidiaries and associates for purposes of preparing consolidated financial statements can be found in IFRS under IAS 27 paragraph 27 and IAS 28 paragraph 28 and US GAAP under ARB 51.

2 Prior to the adoption of IFRS, some national accounting practices permitted the preparation of consolidated financial statements without conforming the accounting policies for measuring insurance contracts. As the IASB did not wish to change the accounting model for insurance contracts and DPF investment contracts until it completed Phase II of the Insurance Contract project, IFRS 4 permits an entity to continue to use non-uniform accounting practices for recognising and measuring insurance contracts and DPF investment contracts. IFRS 4 permits continued application of existing practices but does not permit the introduction of new diversity (IFRS 4 paragraphs 25(c) and BC 131-132).

2.5.3 Deferred tax impacts

Deferred tax impacts form part of the purchase price allocation in business combination accounting.

In general, there are two broad types of deferred tax impacts that require consideration.

- **Deferred tax adjustments for fair value to tax temporary differences for net tangible and intangible assets acquired.** In the PPA, deferred tax impacts should be recognised for the differences between the fair values and tax bases of the individual tangible and intangible assets acquired and the liabilities and contingent liabilities assumed at enacted tax rates.[1] It is important to ensure that the opening balance sheet includes an adjustment to fair value for each asset acquired and each liability assumed, along with a corresponding deferred tax balance, where appropriate and in accordance with IFRS and US GAAP.
- **Deferred tax gross-up adjustments on the fair value of acquired insurance contracts when the expanded presentation is used (VBI asset).** The fair value of assets acquired and liabilities assumed is always a net of tax amount. After recognising an asset or a liability an entity shall determine if the tax base for recognised assets and liabilities is different from the recognised accounting amount. Deferred tax liabilities are recognised when the tax base is temporarily lower than the carrying amounts of assets or temporarily higher than the carrying amount of liabilities. Similarly a deferred tax asset is recognised when temporary differences with the opposite sign exist. In a PPA the fair value determination of insurance liabilities, especially when presenting separately the VBI asset, is computed on an after-tax basis. Our view is that a deferred tax step-up adjustment (or 'gross up') should be applied to present appropriately the tax implications of the fair value of acquired insurance liabilities.[2] The rationale for our position is that even if the VBI asset is recognised on a net of tax basis its carrying amount would always attract a deferred tax liability when it is compared with its tax base (usually nil or a significantly lower amount).

... Some thoughts to take away concerning the deferred tax impacts ...

The tax impacts associated with the valuation of acquired in-force contracts and acquired intangible assets should be discussed early in the PPA process amongst the accountants, valuation specialists, actuaries and tax specialists including:

- **Deferred tax on the VBI asset:** This topic has been subject to hot debate. The issue has been whether a deferred tax liability should be recognised because the tax base of the VBI asset is usually nil or significantly lower than the accounting amount. Although the VBI asset is calculated net-of-tax, there is no basis to avoid the recognition of a deferred tax liability with consequential increase in goodwill. To recognise the appropriate goodwill amount the VBI asset should be recognised on a gross-of-tax basis with a corresponding deferred tax liability recognised to reflect the overall after-tax fair value of the insurance liabilities acquired. We believe that this gross-of-tax accounting approach of VBI assets is now generally applied.
- **The step-up adjustment to the VBI asset:** It can be done in several ways. The 'gross up' of the net-of-tax amount can be a complex exercise if the tax regime is not operating on a simple proportional tax rate basis (eg the UK tax regime for life insurers, which is particularly complex and a simple gross up would not produce the correct figures). The approach that has proved to be the most reliable is based on separating the tax cash flows from all other cash flows considered in the determination of the VBI asset. The resulting amounts will be used to account for the gross-of-tax asset and the associated deferred tax liability.

1 Recognition of deferred taxes is found in IFRS 3 paragraph B16 and IAS 12 paragraphs 19 and 66 and in US FAS 141 paragraph 38 and US FAS 109 paragraph 30.
2 The deferred tax step-up adjustment would appear to be appropriate per IAS 12 paragraph 7.

Illustrative example of deferred tax impact associated with the VBI asset:
Source: Old Mutual 2006 financial statements

22 Deferred tax assets and liabilities continued

(ii) Deferred tax liabilities
The movement on the deferred tax liabilities account is as follows:

£m

	1 January 2006	Income statement charge/ (credit)	Charged/ (credited) to equity	Acquisition/ disposals of subsidiaries	Foreign exchange and other movements	31 December 2006
Accelerated tax depreciation	2	2	–	–	1	5
Deferred acquisition costs	302	63	15	–	(42)	338
Leasing	157	30	–	–	(14)	173
PVIF	–	(62)	–	375	(2)	311
Other acquired intangibles	–	(9)	–	119	(1)	109
Available for sale securities	18	13	(26)	–	(1)	4
Other temporary differences	132	274	(11)	99	(41)	453
	611	311	(22)	593	(100)	1,393

2.5.4 Allocation of goodwill to segments/units

Both US GAAP and IFRS require acquired assets and liabilities, including goodwill, to be allocated to reporting units (US GAAP) or to cash-generating units (IFRS). The allocation is based on how management looks at the business acquired within the overall group. In many cases, but not all, the business acquired will be merged into existing operations.

The goodwill and the net assets acquired are attributed to the operating units[1] that benefit from synergies, even if they are not receiving any assets or liabilities from the acquired business.

Allocations must be reasonable and supportable. Allocated assets and liabilities should be (i) employed in and relate to the operations of their assigned reporting unit, (ii) considered in assessing the fair value of that unit, and (iii) allocated in a manner consistent with how management assesses operating performance. Allocation should be considered carefully at the time the PPA is completed because different allocations could lead to different post-acquisition impairment charges. Points to consider are set out below.

- The basis by which management determine allocations should be documented (this may not necessarily be based on the legal form of the acquirer's group structure).
- The allocation can be complicated in cases where the economic benefits associated with the acquired business can fall into more than one operating unit (eg, insurance, asset management, etc).
- The allocation of goodwill to a unit that may not receive the economic benefits/synergies arising from the acquisition can result in a goodwill impairment charge, even though the overall enterprise-wide value of the reporting group as a whole has not declined.
- The existence of internally generated intangible assets (not recognised under IFRS and US GAAP) can provide a goodwill shield because the cash flows from such assets can contribute to a fair value in excess of the carrying amount of goodwill. However, when a non-performing acquisition begins to absorb the goodwill shield (ie, the reporting unit's fair value and book value begin to converge), the risk of a goodwill impairment charge increases.
- A pro-rata allocation based on earnings expected from the acquisition in each of the units or segments may be the most intuitive method. However, it is necessary to consider all facts and circumstances involved, especially as this method can be difficult to support and presents a higher risk of manipulation. We do not support this approach.

Until the business is restructured, the allocation of goodwill is permanent. Management should take care to consider all of the possibilities for synergy realisation when allocating goodwill to reporting units. Overall, the best defence an acquirer can employ in avoiding impairment charges is a well-executed acquisition and business strategy that generates the expected returns from the capital invested.

1 The units being referred to here are the cash-generating units (CGU) or groups of CGUs for IFRS (IAS 36 paragraph 80), or the reporting units (RU) under US GAAP (US FAS 142 paragraphs 30–31). This level can be lower than a segment under IFRS and US GAAP. A CGU is typically a lower level than a RU resulting in a possible IFRS-US GAAP difference (see PwC publication on Similarities and Differences – a comparison of IFRS and US GAAP (October 2007)). However, putting that difference aside, both IFRS and US GAAP require allocation of expected synergies of the combination to the unit (CGU or RU), irrespective of whether assets or liabilities of the acquired entity are assigned to those units.

2.5.5 Allocation of goodwill to legal entities

The allocation of goodwill to segments and units (for impairment testing) may not necessarily be the same as the allocation of goodwill used for other purposes, as illustrated below.

- Allocation to legal entities can affect two areas: (i) if the acquired entity is publicly quoted it may have to reflect purchase accounting by including goodwill in its local separate financial statements: for example, in the US, the SEC requires push-down accounting to be reflected in the acquired entity's financial statements under certain conditions,[1] and (ii) for tax returns purposes, goodwill allocation as determined by the tax authority could be on a different basis.
- Allocation for foreign currency translation purposes when the acquired entity has a functional currency different from the acquirer as discussed in Section 1.3.2.

2.6 Practical issues concerning the completion of the PPA

Depending on the size and complexity of the acquisition, the PPA process can take up to several months to complete. For insurers, this can result from a number of reasons including, but not limited to:

- The extent to which **due diligence** was undertaken during the pre-deal phase to understand and identify the types of intangible assets and contractual liabilities that were being acquired.
- **The acquirer's experience in applying the current financial reporting standards concerning business combinations.** The acquirer's past experience could determine how effective it is in (i) managing the PPA process at group level, (ii) identifying and gathering the input needed to determine methods and assumptions for valuing the insurance business in the absence of current authoritative guidance, (iii) understanding and pre-empting issues concerning identification and measurement of intangible assets, (iv) assessing the extent to which third-party valuation and actuarial specialists will be involved throughout the deal process including the completion of the PPA, the allocation of goodwill and the post-acquisition impairment testing, and (v) issuing understandable group instructions on the PPA to the acquired entity on a timely basis.
- **Contract data accessibility, availability and testing,** depending on the nature and extent to which the data is maintained by the acquired entity. Delays could be encountered in testing the general controls over data completeness and accuracy from the policy administrative systems back to the details in the policies, especially if numerous legacy systems and/or off-site data management are involved.
- **The process of completing the PPA can take significant time and effort,** principally due to the extensive use of valuation techniques for measuring the acquired intangibles and acquired in-force contracts that will involve management determination of methods and assumptions to be used, the time to perform the actual valuations, possible delays in receipt of valuations from third-party specialists (if used), and use of alternative methods to test their reasonableness and for sensitivity testing.
- **Internal control procedures also apply to the PPA** for companies that report to the SEC. Consideration should be given to the implications under Sarbanes-Oxley on the PPA including (i) the key controls and (ii) management's assessment of their system of internal controls.
- **Language.** The general ability of the acquirer to communicate its financial reporting needs to the acquired entity may be impaired by language barriers and can create a significant obstacle in certain cross-border transactions.

1 Push-down accounting refers to establishing a new basis of accounting in the separate stand-alone financial statements of the acquired entity based on a purchase of stock of the acquired entity. When the acquired entity's operations are maintained in a separate US subsidiary after a business combination, the question arises as to whether the new parent's basis resulting from the business combination should be reflected in the financial statements of the subsidiary. In general, push-down accounting is required for SEC registrants if more than 95% of the voting securities are acquired in a purchase transaction (permitted if 80%–95% has been acquired and prohibited if less than 80% of the entity is acquired). The goodwill pushed down will have to be tested for impairment based on the subsidiary's own reporting units, which may be at a much lower level than the goodwill impairment test performed for the consolidated financial statements. This can result in additional impairment charges.

… Some thoughts to take away concerning the PPA …

The fundamental aspect of a PPA involving an insurance business is the extensive use of valuation techniques to determine fair values at the acquisition date. Factors that should be considered when preparing valuations include, but are not limited, to:

- What is the overall valuation method used, including how the implied growth and/or price multiple was determined and whether it is consistent and reasonable in the context of historical trends, industry or peer group analyses and projections presented to the Board of Directors of the acquirer.
- Is the fair value method used, including assumption setting, applied consistently and properly across the acquired portfolio of in-force contracts and acquired intangible assets?
- Does the acquirer or acquired entity have past experience of fair valuing acquired in-force contracts and/or intangible assets?
- Are all features (terms and conditions) and benefits of the contracts considered?
- Will fair value be developed in reference to a discounted cash flow technique or by use of a recent market transaction?
- If an ***income approach*** using a discounted cash flow technique is being used, to what extent is the approach being refined to capture the following?
  - Will it be based on future distributable IFRS/US GAAP earnings or future distributable regulatory profits?
  - Are the projected cash flows consistent with historical trends, industry analyses, security analysts' reports, operating budgets, prior SEC filings (or its equivalent in non-US jurisdictions), press releases and information provided at analyst meetings? In other words, do the cash flow projections reflect assumptions that a marketplace participant would use rather than the entity-specific assumptions?
  - How are embedded guarantees and options integrated into the estimated future cash flows?
  - Will the risk for variability in cash flows be included in the risk margins or in the discount rate?
  - Are the inherent characteristics of the liability cash flows such as currency, duration, liquidity and credit standing reflected in the risk margins or the discount rate?[1]
  - How has the discount rate been determined? Is it consistent with rates observed in the jurisdiction in which the contracts were issued? Is it commensurate to the risk being measured? Does it take account of the long-term rate of return on the assets backing the insurance business in a manner consistent with the expected timing and amount of the cash flows under the contracts?
  - Will the valuation include a cost-of-capital adjustment?
  - Will the assumptions be based on a single-point set of best estimate assumptions (deterministic approach) or based on multiple sets of assumptions for a probability-weighted cash flow estimate across multiple scenarios (a representative set of scenarios or by a stochastic approach)?
  - Are the valuation inputs reliable and complete?
- If a ***market approac***h is used, does the information used include:
  - A description of the business and the assets acquired compared to the reference business or assets to evaluate the basis for and degree of comparability?
  - Evidence to support the adjustment (premium or discount) applied to adjust the market comparable to the features specific to the asset or liability being valued?
  - Is there source documentation that supports the selected multiples, including the selection of the components of the multiple (eg, new business contribution (NBC), embedded value (EV), earnings before tax, depreciation and amortisation or EBITDA, etc.) and how these align with other multiples observed and/or used in the marketplace subsequent to that transaction?

1 For US GAAP, the consideration of credit standing in the context of fair value measurement may be diverse until US FAS 157 is effective.

2.7 Taking a step back … does the PPA reflect the deal?

The complexities of a PPA require time and effort to measure the individual components of the opening balance sheet at fair value at the acquisition date. The sum of the individual assets and liabilities should reflect the whole of the deal. Therefore, gathering and bringing together the individual pieces of the PPA is an important step towards the completion of the opening balance sheet and can also help to identify gaps or inconsistencies in the PPA.

It is crucial to maintain professional scepticism throughout the PPA process to completion. If the deal was intended to acquire a new distribution channel and an existing block of business, then the goodwill asset would be expected to be relatively small, as the value of the deal would be principally attached to the identifiable intangible assets. In this case, if the draft opening balance sheet shows a large goodwill asset, then management should reassess whether all acquired intangible assets were identified and measured appropriately. On the other hand, if the value of the deal was based predominantly on obtaining a greater share of the market or obtaining the acquired employee workforce, then a greater amount would be attributed to the goodwill asset because such intangible assets cannot be recognised separately according to the current financial reporting standards, but are instead subsumed in goodwill.

Therefore, a key final step for management in completing the PPA is the assessment of the finalised opening balance sheet in the context of the reasons why management entered into the deal in the first place.

That being said, the absence of communication by management would not justify zero recognition of acquired intangible assets in a PPA because the standards require the PPA to be based on the fair values assigned to the individual identifiable tangible and intangible assets acquired, and liabilities and contingent liabilities assumed.

As a final check, management may wish to ask the following types of questions:

- Does the PPA reflect the economics of the transaction as described in the internal memoranda and the external communication? Indeed, this may be used by the capital market regulators to evaluate the appropriateness of the purchase accounting.
- Are the fair value methods appropriate for each of the items being fair valued? Is there sufficient evidence to support the determination of the methods used? Are similar assets and liabilities valued using similar methods?
- Is there sufficient evidence to support the determination of the assumptions used, and are the assumptions consistent with current information in the local marketplace?
- Do the discount rates used reflect the risks specific to the assets and liabilities being measured given that some may carry higher risk than others?
- Is there a link between each of the rates used and the overall implied discount rate? For example, if the memorandum submitted to the Board of Directors quotes a discount rate of 11%, but the discount rate used in the calculation of the VBI is 10%, then what evidence exists to link the 11% with the 10%.
- Have the acquired cash flows been isolated properly, including the separation of the cash flows from a direct customer relationship with policyholders from the cash flows expected from a distribution channel?
- Will there need to be communications to the Audit Committee concerning the valuation methods employed and/or the sensitivity to changes in certain key assumptions?

Chapter three

Day Two, Post-Acquisition Considerations

Post-acquisition financial reporting can have consequences on the deal and should be considered by the acquirer before the transaction is completed. There may be post-PPA adjustments impacting post-acquisition income statement. There may be potential hidden costs involved in establishing a post-acquisition financial reporting infrastructure, which should be ideally considered when the deal price is negotiated. Therefore, although this chapter addresses post-acquisition matters, we encourage that the these issues are considered during the pre-deal phase.

This chapter explores some of the consequences of the deal on post-acquisition financial reporting under IFRS and US GAAP.

3.1 Post-acquisition changes to the PPA

The PPA must be completed within 12 months of the acquisition date.[1] The 12-month period is an 'outer limit': entities should complete the PPA as soon as possible following the acquisition date. Once the cost of the business combination has been determined and all fair values have been evaluated and assigned to the individual assets acquired and liabilities and contingent liabilities assumed, then the PPA is complete.

The **PPA is provisional** if the initial accounting for a business combination cannot be completed (ie, finalised) by the end of the reporting period in which the business combination occurred: this can arise because the determination of a fair value for a specified identifiable asset, liability or contingent liability has not been finalised. If financial statements are issued at the time the PPA is provisional, then a tentative allocation is made using the provisionally determined values accompanied by disclosure indicating that the PPA is provisional (ie not complete) and the reasons why.[2]

Once the **PPA is complete**, subsequent changes to the PPA are recorded as either: (i) a correction of an error to restate the opening balance for an asset or liability with a corresponding adjustment to opening goodwill along with certain required disclosures,[3] (ii) an income or expense item recorded in the post-acquisition income statement, or (iii) an adjustment made to the PPA for certain permitted items specific to contingent consideration, certain deferred taxes and possible changes in certain restructuring provisions.[4] The nature and amount of subsequent adjustments should be disclosed, if material.[5]

Depending on the size and diversity of the insurance business acquired and the issues encountered on identifying and valuing acquired intangible assets and measuring the acquired in-force blocks of contracts, the PPA could take up to several months to complete (as indicated in Section 2.6). Consequently, it can be very difficult to complete the PPA within any one reporting period, especially if the acquirer prepares quarterly financial statements: the shorter the financial reporting period the greater the likelihood that the PPA will be provisional for any one closing.

… Specific comments on the allocation period …

The PPA can be provisional only for specified items for which the acquirer is waiting for information to finalise the fair value measurement. It does not apply to the PPA as a whole.

The 12-month period to complete the PPA is an outer limit that starts from the acquisition date. It should not be seen as a 'window period' for making changes to the PPA.

As insurance business can stretch out for years (eg, asbestos/pollution/environmental claims), there could be a view that the time needed to complete the PPA should be longer than 12 months but there are no industry exceptions to this requirement.

1 Sources for the 12-month limit for completing the PPA: IFRS 3 paragraphs 62 and BC 161 – 162 and US FAS 141 paragraphs 40 – 41 and B183 and definition of the 'allocation period' (Appendix F). This delay is permitted so long as certain conditions are met. Both IFRS and US GAAP indicate that it may not be possible for the acquirer to obtain before the acquisition date all of the information necessary to complete the PPA immediately after the acquisition date. The FASB provided some examples of reasons for such delays, including the delay in obtaining appraisal values and receiving the actuarial determination of the pension liability at acquisition date. However, both the IASB and FASB believe that this is not an indefinite period and established a maximum period of time of 12 months from acquisition date. Furthermore, the FASB indicated that 'the existence of a pre-acquisition contingency does not in itself extend the 'allocation period'' (US FAS 141 paragraph B183). For SEC filers, the SEC has indicated that the purchase price allocation for each item should be finalised as soon as the requested data for that item has been received. In addition, the SEC has indicated that the purchase price allocation (excluding pre-acquisition contingencies) should take significantly less than one year to finalise PwC US Dataline 2002 – 12 (available on www.pwccomperion.com).

2 Sources for the determination of provisional PPA: IFRS 3 paragraphs 62 and 69 and US FAS 141 paragraphs 40 and 51(h).

3 Guidance for correction of error can be found in IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors' and US FAS 154 'Accounting Changes and Error Corrections'.

4 PPA adjustments concerning contingent consideration, certain deferred tax adjustments and restructuring provisions are subject to specific guidance under IFRS and US GAAP. These items are not specific to the insurance sector but rather more general in nature and, therefore, reference can be made to relevant PwC general guidance for these types of adjustments.

5 Source of disclosure: IFRS 3 paragraphs 67 and 69 and US FAS 141 paragraph 51(h).

3.1.1 Illustrative disclosures of a provisional PPA

Illustrative IFRS disclosure of a transaction completed after the reporting date and before the financial statements are issued is provided below.

Source: Old Mutual 2005 IFRS Financial Statements – Skandia acquisition in Feb 2006

Notes to the consolidated financial statements
For the year ended 31 December 2005 *continued*

42 POST BALANCE SHEET EVENTS

On 26 January 2006, the Company's offer for Försäkringsaktiebolaget Skandia (publ) (Skandia) was declared unconditional. Settlement of acceptances received up to that date were executed on 1 February 2006. This resulted in the Company obtaining 72.3% of Skandia. The offer was extended and further acceptances were received up to 9 February 2006, which were executed on 15 February 2006 and which resulted in an aggregate interest of 89.5% of Skandia. The offer remains open for final acceptance until close of business on 14 March 2006.

Under the basic terms of the offer, consideration was paid to shareholders in Skandia by way of a combination of cash and shares in Old Mutual plc. Cash consideration of £1,115 million has been paid by the Company in respect of the acceptances to date and the Company has issued 1,266 million Old Mutual plc shares.

Skandia will be consolidated within the Group's financial statements from 1 February 2006. The fair value balance sheet and goodwill disclosures have not been completed at this time.

Illustrative IFRS disclosure of a completed PPA previously reported as provisional

Source: Manulife 2005 Financial Statements (acquisition of John Hancock in April 2004 -PPA completed in Q2 2005)

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed as at the date of acquisition and has been updated for the finalization of the purchase equation in the second quarter of 2005.

As at April 28, 2004	As reported June 2004	Fair value adjustments	Classification differences	**Final purchase equation**
Assets				
Invested assets	$ 106,647	$ (189)	$ (80)	**$ 106,378**
Intangible assets (note 5)	2,041	–	–	**2,041**
Goodwill	7,441	407	–	**7,848**
Other assets	4,542	(36)	(395)	**4,111**
Total assets acquired	$ 120,671	$ 182	$ (475)	**$ 120,378**
Liabilities				
Policy-related liabilities	$ 95,850	$ 318	$ (395)	**$ 95,773**
Restructuring costs accrued (note 4)	184	34	–	**218**
Other liabilities	10,500	(180)	(80)	**10,240**
Participating policyholders' retained earnings	67	10	–	**77**
Total liabilities assumed	$ 106,601	$ 182	$ (475)	**$ 106,308**
Net assets acquired	$ 14,070	$ –	$ –	**$ 14,070**
Segregated funds net assets acquired	$ 31,020	$ –	$ 395	**$ 31,415**
Total purchase consideration				
MFC common shares	$ 13,510			**$ 13,510**
Cash consideration for partial shares	15			**15**
Fair value of JHF stock options exchanged for MFC stock options	215			**215**
Carrying value of JHF common stock beneficially owned by MFC, prior to acquisition	296			**296**
Transaction costs, net of tax	34			**34**
Total	$ 14,070			**$ 14,070**

The purchase equation with respect to the JHF acquisition was adjusted and finalized during the second quarter of 2005 to reflect various items impacting goodwill. The adjustments have increased goodwill under Canadian GAAP by $407 to $7,848. The adjustments made to goodwill are comprised of:

- Refinement of policy liability valuation models;
- Other refinement of fair values; and
- Additional restructuring accruals.

Refinement of policy liability valuation models include refinements to models and the investment strategies reflected in those models, harmonization of assumptions and assumption changes as a result of further analysis of pre-acquisition experience. In addition, balance sheet reclassifications, which do not affect goodwill, relating to purchase accounting for leveraged lease assets and a product line now classified as a segregated fund, were made in the second quarter of 2005.

3.1.2 Scenarios illustrating the accounting for changes to the PPA

The accounting for changes to the PPA will depend on the following:

- whether the PPA is provisional for that particular item,
- whether the information relates to a development or event subsequent to the acquisition date, to be recorded in the post-acquisition income statement, or
- whether the information relates to facts and circumstances that existed at acquisition date that were overlooked or not correctly applied in the PPA, which should be recorded as a correction of an error with certain additional disclosures.

Three illustrative scenarios are provided below.

Scenario 1: PPA is provisional at reporting date for a specific item. The outstanding information is received seven months after acquisition date.

The InsurerGroup acquired French Lifeco on 30 September 20X1. The PPA has been prepared for French Lifeco and is complete subject to a legal confirmation concerning an unsettled claim of an employee for a worker's compensation claim at acquisition date. For the purposes of the 31 December 20X1 financial statements, a provisional PPA fair value of Euro 50 million was determined based on preliminary information according to IAS 37 and US FAS 5 (time value of money not material in this case for the purpose of IAS 37). InsurGroup disclosed in its financial statements that the PPA was provisional as it was waiting for an outstanding legal confirmation concerning an unsettled litigation case. In April 20X2, seven months after the acquisition date, the lawyers' confirmation was received by InsurGroup indicating that based on the information that existed at the acquisition date the occurrence of an unfavourable settlement was expected to be remote. Does the legal confirmation update the pre-acquisition contingency amount included in the PPA?

Conclusion: Yes. The PPA was provisional for this pre-acquisition contingency item because the acquirer was waiting for information to confirm the facts and circumstances that existed at the acquisition date. The confirmation on the pre-acquisition contingency was received within the 12-month allocation period. The provisional fair value of Euro 50 million is reduced to zero based on information provided in the legal confirmation with a corresponding adjustment to goodwill. The PPA is now complete, seven months after acquisition date.

Scenario 2: Additional information becomes available seven months after the acquisition date concerning claims development.

The InsurGroup acquired P&C Ltd at 30 September 20X1. Three days before the acquisition, 27 September 20X1, there was a factory explosion and P&C Ltd provided 100% bodily injury insurance to the employees of that factory. The claims liability included in the PPA was not provisional as InsurGroup and P&C Ltd were of the view (at the time the financial statements were prepared) that all necessary information concerning the factory explosion had been received and, therefore, the fair value measurement for claims liabilities was complete. In April 20X2, or seven months after the acquisition date, further claims information concerning the factory explosion was received. The information indicated that based on developments subsequent to the acquisition date the expected amount to be paid on the claims will be higher than the amount originally included in the PPA. Is the unfavourable claims development included in the PPA?

Conclusion: No. At April 20X2, the PPA is complete for the claims liability. The information concerning the unfavourable claims development is based on developments or events subsequent to the acquisition date. The adjustment to increase the claims liability is recorded as a charge in the post-acquisition income statement.

Scenario 3: The PPA is complete six months after acquisition date. Additional information becomes available 14 months after acquisition concerning the acquired in-force block of contracts

InsurGroup acquired UK Lifeco on 30 September 20X1. The PPA is completed in March 20X2, six months after acquisition date. In November 20X2, or 14 months after acquisition date, a block of contracts has been discovered. The information concerning these contracts was located in an old warehouse and not included in UK LifeCo's policy administration system (database) that was used to determine the fair value measurement at acquisition date. This block of business was in force at the acquisition date.

Conclusion: The adjustment is recorded as a correction of an error to restate the PPA and opening goodwill. Certain financial statement disclosures will also be required.

... Some thoughts on receipt of subsequent information ...

The receipt of information after the acquisition date that relates to one or more items included in the PPA is common in the insurance industry because of the long-term nature of insurance business and general refinements in estimating liabilities that arise as part of the day-to-day activity as and when information becomes available. Consequently, difficulties can arise in determining whether the subsequent information is a change in estimate recorded in the post-acquisition income statement or a correction of an error.

The facts and circumstances concerning the receipt of subsequent information need to be understood in order to account for it properly. In this regard, the following could be considered:

- What additional information was received?
- Why was the additional information received after the acquisition date?
- Did management have a provisional fair value assigned to that specific item in the PPA at acquisition date because it was waiting for this information?
- Did the information address facts and circumstances that existed at the acquisition date?
- Does the information relate to a post-acquisition development, trend, or a change in financial or economic conditions that would indicate it is a post-acquisition event that should be reflected through the post-acquisition income statement?

As a reminder the PPA completion period in resolving pre-acquisition contingencies stops when the acquirer is no longer waiting for information on the fair values at acquisition date. The 12-month deadline is the outer limit.

There is a general view, held also by certain capital market regulators, that the PPA should not usually take the full 12 months to complete. The point in time when the acquirer is no longer waiting for information to finalise the fair values of the individual assets acquired and liabilities assumed is the point in time when PPA is complete. Adjustments arising from the receipt of subsequent information are recorded as a correction of error or as a charge or credit to the post-acquisition income statement, except for items such as contingent consideration, certain deferred tax adjustments and restructuring provisions, which are permitted under IFRS and US GAAP.

'Correction of an error' and 'changes in estimate' are concepts applied under IFRS and US GAAP, see Glossary for further information.

3.2 Post-acquisition tour of acquired insurer's balance sheet

The post-acquisition accounting for each balance sheet caption of the acquired business used for consolidation purposes is presented in the following table. The table applies to both IFRS and US GAAP, unless otherwise indicated. Further general guidance on IFRS-US GAAP differences can be found in a PwC publication on Similarities and Differences IFRS-US GAAP (October 2007). The balance sheet captions are presented by order of increasing liquidity, a format generally observed in Europe.

The US GAAP information discussed in the table below is based on current accounting guidance in effect at the time of writing. From time to time the FASB will issue guidance concerning existing and new US GAAP standards. A full list can be found on the FASB's website under http://www.fasb.org/project/recent_effective_dates.shtml. These developments, which will affect future periods starting from 2008 calendar year, have not yet been incorporated in the table below including , but not limited to:

- US FAS 157 'Fair Value Measurements', which provides a definition of fair value and associated measurement basis.[1]
- US FAS 159 'The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115',[2] which permits entities to measure many financial instruments and certain other assets and liabilities at fair value through profit or loss based on an irrevocable instrument-by-instrument designation. Investments that are eligible for the fair value option include mortgage loans, private equity securities held by non-insurance entities (as insurers measure at fair value through equity unless in a designated fair value hedge per FAS 60 as amended) and equity method investments.
- US SOP 07-1 'Clarification of the Scope of the Audit and Accounting Guide, Investment Companies, and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies',[3] which provides guidance for determining whether an entity meets the definition of an investment company for financial reporting purposes and therefore should apply investment company accounting. At the time of writing, the FASB authorized its staff to draft a proposed FASB Staff Position (FSP) that would indefinitely defer the effective date of SOP 07-1. An exposure draft has been issued for comment.

3.2.1 The tour of the balance sheet

Balance sheet caption	Post-acquisition accounting
ASSETS	
Goodwill	Not amortised, but subject to annual impairment testing or when a triggering event occurs. *For further information, see Section 3.4*
Indefinite life acquired intangible assets	

1 **US FAS 157:** It becomes effective for calendar year-end reporting entities from 1 January 2008, unless adopted early. Further information can be found in the Epilogue.

2 **US FAS 159:** It was issued in February 2007 and is effective as of the beginning of the entity's first fiscal year that begins after 15 November 2007. It can be adopted early so long as US FAS 157 is also adopted at the same time. Further information can be found in PwC US Dataline 2007-04 available on www.pwccomperio.com and www.cfodirect.pwc.com.

3 **US SOP 07-1:** It was issued in July 2007 and is effective for fiscal years beginning on or after December 15, 2007, but earlier adoption is encouraged (ie, from 1 January 2008 for calendar year-end reporting entities). Among the significant implications of applying investment company accounting is the reporting of investment activities at fair value. It also could affect the accounting for certain investment funds and partnerships which are accounted for under the equity method of accounting or are consolidated as a subsidiary given SOP 07-1 partially nullifies the consensus in EITF Issue 85-12 'Retention of Specialized Accounting for Investments in Consolidation' (US EITF 85-12). Further information can be found in PwC US Dataline 2007-14 available on www.pwccomperio.com and www.cfodirect.pwc.com.

Balance sheet caption	Post-acquisition accounting
Finite life acquired intangible assets	Amortised over their estimated useful lives in line with consumption of economic benefits. Subject to an impairment test if triggering events occur. Required to review the useful life and amortisation patterns on an annual basis. *For further information, see Section 3.2.2.1* Specific for certain service contracts under US GAAP, US FAS 156[1] provides certain guidance concerning the initial and subsequent measurement of separately recognized servicing assets and servicing liabilities (which includes an acquisition or assumption of an obligation to service a financial asset that does not relate to financial assets of the servicer or its consolidated affiliates). For purposes of subsequent measurement, US FAS 156 gives an entity the choice to use an amortisation method (the same method prescribed by FAS 140 for measuring servicing assets and servicing liabilities), or a fair value measurement method (being fair value through P&L), among other things. The subsequent measurement method is an irrevocable election to be made separately for each "class" of servicing assets and servicing liabilities. Different elections can be made for different classes of servicing assets or servicing liabilities.
Value of business in-force (VBI) *(under expanded presentation)*	VBI amortised according to GAAP requirements, typically in relation to the level of premiums or in line with profit emergence, depending on the contract. *For further information, see Section 3.2.2.2*
Fair value adjustments on non-life undiscounted claims liability and unearned premium liability *(under expanded presentation)*	If claims liabilities are reported on an undiscounted basis, then the difference between the undiscounted amount and the discounted amount is reported as an asset (under expanded presentation). The asset is amortised according to the actual settlement of the claims. *For further information, see Section 3.2.2.3.*
Debt investment securities *(quoted and unquoted)*	Specific to IFRS, securities are designated as trading, available-for-sale (AFS), held-to-maturity (HTM), or possibly (under IFRS) 'loans & receivables' or the 'fair value option' as described in IAS 39. The designation is based on group accounting policies of the acquirer. Specific to US GAAP, securities are designated as trading, AFS or HTM as described in US FAS 115. Even though the fair value option is a specific IFRS reference, it can be considered in many cases as the equivalent of the practical basis by which 'trading' is applied under US GAAP.[2] In addition, the FASB has recently introduced the concept of fair value option for certain hybrid financial instruments under US FAS 155.[3] The designation is based on group accounting policies of the acquirer. The accounting for securities held by consolidated investment funds within insurance groups are measured at fair value through profit or loss for all investments held by qualifying investment companies according to current specialised industry accounting guidance issued by the AICPA. Overall and under both IFRS and US GAAP the fair value at acquisition date becomes the new cost base for the post-acquisition reporting period for group reporting purposes (this may not change the historical cost used by the acquired business in its local separate financial statements, unless SEC push-down accounting applied). In addition for securities designated at AFS, HTM or for IFRS 'loans & receivables', any premium or discount from par value at the purchase date (or the amount expected to be received in the case of troubled securities) would be amortised using the effective interest method in subsequent periods.

1 US FAS 156 'Accounting for Servicing of Financial Assets' is effective for fiscal years beginning after 15 September 2006 (ie, 1 January 2007 for calendar year-end reporting entities). US FAS 156 amends US FAS 140 'Acounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities', with respect to the accounting for separately recognized servicing assets and servicing liabilities. Further information can be found in PwC US Dataline 2006-10 available on www.pwccomperio.com and www.cfodirect.pwc.com.

2 US FAS 115 Q&A Implementation Guidance Q34 and Q35.

3 US FAS 155 'Accounting for Certain Hybrid Financial Instruments' is effective for fiscal years beginning after 15 September 2006 (ie, 1 January 2007 for calendar year-end reporting entities). US FAS 155 resolves the accounting issues associated with beneficial interests in securitised financial assets. It permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation and provides certain other clarifications. Further information can be found in PwC US Dataline 2006-27 available on www.pwccomperio.com and www.cfodirect.pwc.com.

Balance sheet caption	Post-acquisition accounting
Equity investment securities *(quoted and unquoted)*	Specific to IFRS, securities are designated as trading, available-for-sale (AFS), or under the 'fair value option' as described in IAS 39. The designation is based on group accounting policies of the acquirer. Even though the fair value option is a specific IFRS reference, it can be considered in many cases as the equivalent of the practical basis for which 'trading' is applied under US GAAP.[1] The designation is based on group accounting policies of the acquirer. Specific to US GAAP, securities are designated as trading or AFS as described in US FAS 115. In addition, (i) insurers are required to account for unquoted equity securities measured at fair value through equity per US FAS 60 as amended, and (ii) accounting for securities held by consolidated investment funds within insurance groups are measured at fair value through profit or loss for all investments held by qualifying investment companies according to current specialised industry accounting guidance issued by the AICPA. Overall and under both IFRS and US GAAP, the fair value at acquisition date becomes the new cost base for the post-acquisition reporting period for group reporting purposes (this may not change the historical cost used by the acquired business in its local separate financial statements unless SEC push-down accounting is applied).
Real-estate investments	**If amortised cost used:** The fair value at acquisition date becomes the cost basis for calculating a realised gain or loss if the property is later sold. The value attributed to buildings and equipment is depreciated over their estimated useful lives as of the purchase date. This is optional under IFRS and required under US GAAP (unless in qualifying separate accounts). **If fair value through income statement used:** This is for investment property so long as certain conditions are met. Subsequent changes to fair value following the acquisition date are recorded in income statement. This option is only available under IFRS under IAS 40 and for property held in US qualifying separate accounts.
Mortgage loans	As if the loan was purchased directly for fair value on the purchase date. Under US GAAP or IFRS amortised cost basis (if designated as 'loans & receivables'), any premium or discount from the unpaid principal balance at the purchase date would be amortised using the interest method and contractual maturity dates. Currently only IFRS permits designation at fair value through profit or loss under the 'fair value option' if certain criteria are met based on group accounting policies of the acquirer. However, this difference with US GAAP will change with the adoption of US FAS 157 and US FAS 159 in future periods.
Policy loans	As if the loan was purchased directly for fair value on the purchase date. Assuming it is a separate financial asset and not part of the valuation of the contract liabilities, under US GAAP or IFRS an amortised cost basis will be used (if designated as 'loans & receivables'). Any premium or discount from the unpaid principal balance at the purchase date would be amortised using the interest method and contractual maturity dates. IFRS also permits designation at fair value through profit or loss under the 'fair value option' if certain criteria are met, based on group accounting policies of the acquirer.
Other investments	As if the investment was purchased directly for fair value on the purchase date. Accounting is based on group accounting policies.

1 US FAS 115 Q&A Implementation Guidance Q 34 and Q35.

Balance sheet caption	Post-acquisition accounting
Property, plant and equipment used in the business (property for operating purposes including owner-occupied property)	As if the plant and equipment was purchased directly for fair value on the purchase date. **If amortised cost used:** Value attributed to buildings and equipment is depreciated over their estimated useful lives as of the purchase date and the resultant depreciated cost becomes the basis for realised gain or loss calculations if the plant and equipment is subsequently sold. This is optional under IFRS and required under US GAAP (unless in qualifying separate accounts). **If fair value through equity used:** This option is only available under IFRS under IAS 16 for property that is held for operating purposes and owner-occupied property. Subsequent changes to fair value following the acquisition date are recorded in equity.
Due and accrued investment income	As if the securities to which the due and accrued income relate were purchased directly for fair value on the purchase date. Accounting is based on group accounting policies.
Deferred acquisition costs ('DAC')	Acquisition costs only for post-acquisition new insurance business that meet the recognition and measurement requirements under US GAAP or IFRS are deferred and amortised over estimated contract life. Accounting is based on group accounting policies.
Deferred origination costs ('DOC')	**IFRS:** Relates to post-acquisition new business concerning unit-linked investment contracts according to IAS 18. Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and it is probable that such costs can be recovered. This asset is amortised on the basis similar to which the related revenue is recognised. **US GAAP:** Not applicable, account for as DAC.
Receivables, including premiums receivable and receivables from reinsurers	Same as 'mortgage loans'.
Assets acquired and held-for-sale (held for disposal)	The fair value less cost of sale established on the purchase date becomes the cost basis for realised gain or loss calculations when the plant and equipment is sold.
LIABILITIES AND EQUITY	
Common and preferred stock	Acquirer's group accounting policy, which should be a continuation of pre-purchase accounting policy.
Additional paid in capital	
Retained earnings	
Unrealised gains and losses on available-for-sale securities *(ie, OCI under US GAAP)*	Includes cumulative unrealised gains and losses along with any shadow VBI or post-acquisition shadow DAC, attribution to participating benefits and deferred taxes and other charges recognised subsequent to the acquisition date.
Long-term debt and borrowings	As if the security was issued directly for fair value on the purchase date. Any premium or discount from par value at the purchase date would be amortised using the interest method. Under IFRS, subsequent measurement could be based on an amortised cost method (whereby any premium or discount from par value at the purchase date would be amortised using the effective interest method) or fair value through profit or loss so long as the 'fair value option' criteria described in IAS 39 are met. Under US GAAP, similar to IFRS especially with US FAS 159 that will soon be effective under US GAAP. However, differences can arise including the fact that there are specific measurement criteria for certain financial instruments.
Pre-acquisition contingencies	Once the fair value allocation is finalised, differences between the recorded value and the ultimate settlement value are recorded in income statement according to group accounting policies.

Balance sheet caption	Post-acquisition accounting
Defined benefit pension plan of a single employer	Continuation of pre-purchase accounting policy but with consideration given to circumstances where there are curtailments or settlements. Differences between US GAAP and IFRS exist in the definition, timing and measurement especially for the treatment of actuarial gains (loss) and plan curtailment, amongst other things. Further guidance is provided in a PwC publication in Similarities and Differences IFRS-US GAAP (October 2007).[1]
Defined postretirement benefit plan of a single employer	
Life insurance contract liabilities including insurance contracts with DPF[2] *(significant mortality / morbidity risk)*	**For post-acquisition new business:** Contracts are recognised and measured according to group accounting policies. The underlying basis for recognising and measuring the contracts under IFRS may not necessarily be similar to that used for US GAAP. **For acquired business:** If the indirect method and expanded presentation are used, then this will be the recorded liability under IFRS/US GAAP. Please note that the underlying recorded value may differ under IFRS (ie, existing accounting policies) as compared to US GAAP. Need to consider the facts and circumstances involved. *The IFRS/US GAAP requirements are briefly described in Section 2.2.2.1.*
Investment contracts with DPF *(No or insignificant insurance risk with certain participating features as defined under IFRS 4)*	**For post-acquisition new business:** Contracts are recognised and measured according to group accounting policies. The underlying basis for recognising and measuring the contracts under IFRS may not necessarily be similar to that used for US GAAP. **For acquired business:** If the indirect method and expanded presentation are used, then this will be the recorded liability under IFRS/US GAAP. Please note that the underlying recorded value may differ under IFRS (ie, existing accounting policies) as compared to US GAAP. Need to consider the facts and circumstances involved. *The IFRS/US GAAP requirements are briefly described in Section 2.2.2.1.*
Unit-linked investment contracts *(No or insignificant insurance risk with investment risk borne by policyholders with no DPF)*	**For post-acquisition new business:** Contracts are recognised and measured according to group accounting policies. The underlying basis for recognising and measuring the contracts under IFRS may not necessarily be similar to that used for US GAAP, especially if the contracts do not qualify as US SOP 03-1 'separate accounts'. **For acquired business:** • **IFRS:** A deposit component is recognised as a financial liability. It will be accounted for under IAS 39 at amortised cost or at fair value through profit or loss whereby the initial measurement of the financial liability is the value determined in the PPA. • **US GAAP:** If the indirect method and expanded presentation are used, then the underlying recorded value will be in reference to account balance. *The IFRS/US GAAP requirements are briefly described in Section 2.2.2.1.* *Note that IFRS separate presentation of the 'deposit component' and the 'service component' and the use of expanded presentation under US GAAP could result in IFRS-US GAAP differences in asset classification and possible measurement differences (the latter can occur if the surrender charges are significant). For further information, see Section 2.2.2.4.*

1 Insurance benefit liabilities are also referred to as technical provisions or future policy benefit reserves in many jurisdictions. These types of contracts may also include a liability for certain types of participating benefits.

Balance sheet caption	Post-acquisition accounting
Non-linked investment contracts without DPF	**For post-acquisition new business:** Contracts are recognised and measured according to group accounting policies. The underlying basis for recognising and measuring the contracts under IFRS may not necessarily be similar to that used for US GAAP. **For acquired business:** • **IFRS:** The financial liability will be accounted for according to IAS 39 at amortised cost or at fair value through profit or loss whereby the initial measurement of the financial liability is the value determined in the PPA. • **US GAAP:** If the indirect method and expanded presentation are used, then the underlying recorded value will be in reference to account balance or, in its absence, a US FAS 91 amount; otherwise, a discounted cash flow method is used. *The IFRS/US GAAP requirements are briefly described in Section 2.2.2.1.* *Note even if a discounted cash flow method is applied under both IFRS and US GAAP, differences can arise because under IFRS the financial liability cannot be lower than the present value of the surrender amount, which is not a concept under US GAAP. See Section 2.2.2.4.*
Deferred revenue liability	**For post-acquisition new business:** Initiation or front-end fees are recognised and measured according to group accounting policies. For acquired business: • **IFRS (onerous contract, if applicable):** The deferred income liability is subsumed in the contract customer relationship asset. A liability exists only if the contract is onerous. This latter scenario would be the case when there are no positive cash flows arising from the contractual arrangement. The liability would be derecognised through income according to the pattern of the service rendered.[1] • **US GAAP:** Practice varies. The future costs and charges should be implicitly included in the fair value. However, it could be presented as a separate liability adjusted to fair value that would be amortised over the period in which service is to be rendered. *For further information, see Section 2.2.2.4.*
Non-life insurance claim liabilities including claims settlement costs	**For post-acquisition new business:** Recognised and measured according to group accounting policies. **For acquired business:** This item could be presented either as a discounted amount or as an undiscounted amount using expanded presentation with the fair value adjustment presented as a separate asset. *For further information, see Sections 2.2.1, 2.2.1.1 and 2.2.3.*
Insurance unearned premium liabilities	**For post-acquisition new business:** Recognised and measured according to group accounting policies. **For acquired business:** This item could be presented either as a discounted amount or as an undiscounted amount using expanded presentation with the fair value adjustment presented as a separate asset. *For further information, see Sections 2.2.1, 2.2.1.2 and 2.2.3.*
Deferred income taxes	Continuation of pre-purchase accounting policy but based on deferred tax amounts reflected in opening balance sheet and in subsequent periods. Special consideration for differences in treatment of deferred tax income benefits from income tax loss carry-forwards on goodwill (IFRS versus US GAAP)
Accounts and notes payable, and other claims payable; liabilities and accruals	Acquirer's group accounting policy, which is usually a continuation of pre-purchase accounting policy.

1 The IFRS guidance concerning deferred revenue liability expressed in the table represents our view. We also understand that there is a possible alternative view to recognise both the deferred revenue liability and DAC on investment contracts in a business combination, however, we do not believe that this is consistent with the requirements of IFRS 3 to fair value all assets acquired and liabilities assumed.

3.2.2 Amortisation of finite-life acquired intangible assets and VBI asset

3.2.2.1 Amortisation of finite-life acquired intangible assets

The method of amortising a finite-life intangible asset should reflect the expected pattern of consumption of the anticipated future economic benefits embodied in the asset and should be applied consistently in each reporting period.1 The amortisation method should be linked to the fair value approach used in the PPA. This holds true especially if an excess-earnings methodology is used to determine the fair value of the identifiable intangible asset: in this case, the amortisation method should usually be consistent with the timing and pattern of cash flows reflected in the valuation. If the amortisation pattern cannot be reliably determined, then a straight-line amortisation method is required.

Depending on the type of acquired intangible asset, the amortisation pattern could be more skewed to the earlier periods, more skewed to the later periods, or possibly evenly spread over the estimated useful life so long as supportable: it depends on the pattern of economic benefit or accounting margins. Care should be taken in these cases (especially in the context of IFRS reporting) because IAS 38 indicates (in paragraph 98) that there is rarely, if ever, persuasive evidence to support an amortisation method for finite-life intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.[2]

Guidance for amortising acquired intangible assets specific to an insurer is provided in the table below.

Type of Intangible Asset	Useful life and amortisation pattern
Customer relationships - direct customer relationship with policyholder	The assigned useful lives of contractual and customer-related intangibles will vary considerably based on the facts involved for each specific case. The complexity stems from the fact that every business essentially comprises a series of contractual customer relationships. Useful life is dependent on contract duration and evidence supporting contract renewals and persistency. In relation to non-life one-year renewal business, the useful life could be fairly short term. In relation to life & savings business, certain contracts do not provide any form of contractual obligation on the part of the policyholder to pay future premiums, but provide some option to the policyholder to pay future premiums for which the amount and timing are at the sole discretion of the policyholder with the benefits based on the terms and conditions of the original contract. These may be referred to as recurring single premium contracts and should not be confused with regular-premium paying contracts. In the former case, the acquirer would not only acquire the profit margins on the existing contracts in-force (commonly included in the VBI asset) based on paid-up premiums but also the value of expected future profit margins that may arise on existing policyholders' option to pay, at their discretion, future premiums under existing contract terms and conditions (a renewal right intangible asset). In this case the asset is accounted for under IAS 38 rather than IFRS 4 and its useful life could extend up to 20-30 years with amortisation based on expected distributable earnings or future premiums.
Customer relationships-distribution channels	The assigned useful lives will vary considerably based on the facts involved for each specific case. Amortisation in relation to economic benefits could be based, for example, on the expected distributable earnings or future premiums.

1 Amortisation period and amortisation method: IAS 38 paragraph 97 and US FAS 142 paragraphs 11-12

2 Reference to use of straight-line amortisation: IAS 38 paragraph 98 and US FAS 142 paragraphs 12, B54-55 and B62. Concerning IAS 38 paragraph 98, the IASB has recently issued an Exposure Draft of proposed 'Improvements To International Financial Reporting Standards' in October 2007 in which it proposes to amend IAS 38 by removing the last sentence of paragraph 98 which states 'there is rarely, if ever, persuasive evidence to support an amortisation method for intangible assets with finite useful lives that results in a lower amount of accumulated amortisation than under the straight-line method.' The Board has been informed that in practice the words 'rarely, if ever' are interpreted as 'never' which is contrary to the fact that there may be evidence to suggest an expected pattern of consumption that is weighted to the end of the asset's life (eg, as that highlighted in their discussions on service concessions). If this proposed amendment is confirmed, the Board intends for it to be effective for annual periods beginning on or after 1 January 2009. It is proposed that early application would be permitted so long as (i) all of the proposed amendments from the first annual improvements project are applied, and (ii) revisions to IAS 1 'Presentation of Financial Statements' in 2007 are also applied.

Type of Intangible Asset	Useful life and amortisation pattern
Customer lists/member lists	The intangible is amortised in relation to economic benefits. Lists typically go out of date rather quickly and, therefore, we would expect them to have a short useful life. However, we have observed, for example, in one US transaction that member lists for US health providers had an average amortisation period of 15 years as a result of specific facts and circumstances.
Brands, trade names and trademarks	Evidential support could include studies or analysis concerning brand recognition in the marketplace. Marketing-based intangibles could have a long useful life or even qualify for indefinite-life treatment if their useful lives are not limited contractually and they can generate value over extended periods of time. But at the same time, short lives are common with amortisation on a straight-line basis depending on the strength and importance of the brand.
Insurance licences	The estimated useful life of a licence may appear to be fairly straightforward based on contract terms. However, complexities arise when the licence includes renewal features at little or no cost that could extend the estimated useful life. Insurance licences are considered to be indefinite-life intangible assets if they can be maintained indefinitely without substantial cost, however, the final determination has to be based on the specific facts and circumstances involved.
Service contracts, provider contracts and outsourcing of costs	If amortised, the useful life should be based on the length of the contract or historic experience, usually amortised in relation to the economic benefits or accounting profits.
Customer relationships – fund management (asset management) contracts	The useful life should consider the terms of the contract. The amortisation period may be longer where the focus is on institutional clients rather than retail clients.
Non-compete agreements	The useful life should be based on the length of the contract or historic experience, usually amortised on a straight-line basis over the period of the non-compete agreement.
Computer software and internet domain names	The useful life should be based on the length of the expected use of the software which is typically a short period of time (three to five years), usually amortised on a straight-line basis.
Core deposit intangible asset	Recognised in the context of investment contracts without DPF under IFRS. This does not apply to US GAAP where a VBI asset is recognised (see Section 2.2.2.4). Core deposit intangibles have a finite useful life and must be amortised using a method that reflects the pattern in which the economic benefit of the asset is consumed. For core deposit intangibles, this results in the use of an accelerated method of amortisation over periods not exceeding the estimated average remaining life of the existing customer deposit bases acquired.

The insurer is required to review the amortisation period and method of amortisation at least annually (under IFRS) or at each reporting period (under US GAAP). In the event of a subsequent change in the expected pattern of consumption of future economic benefits, the change in amortisation will be recorded as follows:[1]

- **IFRS:** A change in estimate that is recorded in the period of change if the change affects that period only, or in the period of change and future periods if the change affects both.
- **US GAAP:** The remaining carrying amount of the intangible asset is amortised prospectively over the revised remaining useful life.

This does not apply to changes in amortisation for the VBI asset, see Section 3.2.2.2.

Refer to Section 3.4 concerning impairment tests.

1 Changes in useful life and amortisation pattern: IAS 38 paragraph 104 and IAS 8 paragraphs 36 – 37 and US FAS 142 paragraph 14 and US FAS 154 paragraph 10.

3.2.2.2 Amortisation of the VBI asset

As indicated in Sections 2.2.2.2 and 2.2.3, the VBI asset may be presented as a separate asset under IFRS and US GAAP. The method of amortising the VBI asset depends on whether financial reporting is conducted under IFRS or US GAAP and contract classification as summarised in the table below.

Contract classification	IFRS	US GAAP
Insurance contracts	Amortisation is based on local GAAP and contract classification. It could be based on level of premiums or profits depending on local GAAP. Subsequent measurement is consistent with the measurement of the related liability according to IFRS 4.	The amortisation methodology will be determined as follows: • US FAS 60 long-duration contracts: amortised as a percentage of premiums. • US FAS 97 contracts: US FAS 60 basis in respect of the future premium margins, which are amortised over the remaining contract term using the amount of insurance as the basis for earnings recognition. • US FAS 120 contracts: based on estimated gross margins.
DPF investment contracts	Same as for 'Insurance Contracts' above	
Non-linked investment contracts without DPF	VBI asset is not applicable[1]	
Unit-linked investment contracts	VBI asset is not applicable[2]	

The useful life of the VBI asset is dependent on contract duration and persistency (see illustrative examples of disclosure provided under US GAAP and IFRS below).

The accounting for a change in the amortisation of the VBI asset is not the same as that described for acquired intangible assets in Section 3.2.2.1. The accounting for the change in amortisation of the VBI asset is described below.

- **IFRS:** For insurance contracts and DPF investment contracts that are in the scope of IFRS 4, the accounting for change in amortisation of the VBI asset should follow local GAAP. For investment contracts without DPF that fall under IAS 39, reference is made to the guidance in Section 3.2.2.1, as the asset concerned is not a VBI asset but an acquired intangible asset.
- **US GAAP:** Interest is accrued on the unamortised VBI asset balance. The interest rate used to amortise the VBI asset should be the liability or contract rate. For US FAS 60 insurance contracts, if estimates of future premiums change, there is no adjustment beyond that needed to reflect deaths and surrenders.[3] For US FAS 97 investment contracts and universal life contracts, changes in estimates of expected future gross profits or margins should be, depending on the significance of the change, accounted for as a 'catch-up' adjustment recorded as either a charge or a credit to the income statement **(a retrospective adjustment)**.[4]

This could lead to IFRS-US GAAP differences, see Section 1.7.

Refer to Section 3.4 concerning impairment tests.

1 The asset recognised is not a VBI asset but a core deposit intangible asset that is amortised as the entity recognises the related revenue according to IAS 18. The core deposit intangible asset is described in Section 2.2.2.4 (the concept), in Section 2.3 (the measurement), and in Section 3.2 (the amortisation).

2 The asset is not a VBI asset but rather a customer relationship (see 'Unit-linked investment contracts' under Section 2.2.2.4 and for amortisation refer to Section 3.2.2.1).

3 US EITF 92-9.

4 Some insurers have made reference to limited guidance on insurance purchase accounting found in US EITF 92-9, which alleviated some then-existing diversity in practice of post-purchase accounting for VBI by clarifying that VBI should be amortised in a manner similar to the amortisation of DAC for directly issued business. It will also include an interest accrual on the unamortised balance. Because the VBI asset is not an intangible asset, the VBI asset prescribed under US EITF 92-9 is not affected by the guidance included in US FAS 141 and US FAS 142. Changes to the amortisation of the VBI asset during the contract life (if amortised according to profits, estimated gross profits, or estimated gross margins), will be accounted for according to US EITF 92-9 under a cumulative catch-up approach that is different from the prospective approach under US FAS 142.

Illustrative examples of disclosure concerning VBI amortisation
Source: Metlife's 2005 Consolidated Financial Statements (US GAAP)

Other Intangible Assets

VOBA reflects the estimated fair value of in-force contracts acquired and represents the portion of the purchase price that is allocated to the value of the right to receive future cash flows from the life insurance and annuity contracts in force at the acquisition date. VOBA is based on actuarially determined projections, by each block of business, of future policy and contract charges, premiums, mortality and morbidity, separate account performance, surrenders, operating expenses, investment returns and other factors. Actual experience on the purchased business may vary from these projections. If estimated gross profits or premiums differ from expectations, the amortization of VOBA is adjusted to reflect actual experience.

The value of the other identifiable intangibles reflects the estimated fair value of Citigroup/Travelers distribution agreement and customer relationships acquired at July 1, 2005 and will be amortized in relation to the expected economic benefits of the agreement. If actual experience under the distribution agreements or with customer relationships differs from expectations, the amortization of these intangibles will be adjusted to reflect actual experience.

The use of discount rates was necessary to establish the fair value of VOBA, as well as the other identifiable intangible assets. In selecting the appropriate discount rates, management considered its weighted average cost of capital as well as the weighted average cost of capital required by market participants. A discount rate of 11.5% was used to value these intangible assets.

The fair values of business acquired, distribution agreements and customer relationships acquired are as follows:

	As of July 1, 2005 (In millions)	Weighted Average Amortization Period (In years)
Value of business acquired	$3,780	16
Value of distribution agreements and customer relationships acquired	662	16
Total value of amortizable intangible assets acquired	4,442	
Non-amortizable intangible assets acquired	—	
Total value of intangible assets acquired, excluding goodwill	$4,442	16

The estimated future amortization of the values of business acquired, distribution agreements and customer relationships acquired from 2006 to 2010 is as follows:

	As of December 31, 2005 (In millions)
2006	$376
2007	$363
2008	$347
2009	$330
2010	$307

Source: AXA's 2006 Consolidated Financial Statements – An analysis of VBI year-on-year (IFRS)

Note 6: Value of purchased life business inforce

The change in Value of Business Inforce ("VBI") in the Life & Savings segment was as follows:

(in Euro million)

	2006	2005	2004
Gross carrying value as at January 1	5,760	5,474	5,005
Accumulated amortization and impairment	(2,444)	(1,821)	(1,414)
Shadow accounting on VBI	(694)	(530)	(380)
Net carrying value as at January 1	**2,623**	**3,123**	**3,210**
Increase following Life portfolio acquisitions	–	–	–
Decrease following Life portfolio disposals	–	–	–
Increase following new subsidiaries' acquisitions	2,575	–	694
Decrease following subsidiaries' disposals	–	–	–
Decrease following the transfer of portfolios to the "held for sale" category	–	–	–
Impacts on VBI of changes in scope and portfolios transfers	**2,575**	**–**	**694**
VBI capitalization	7	8	–
Capitalized interests	138	155	56
Amortization and impairment for the period [(a)]	(428)	(722)	(524)
Changes in VBI amortization, capitalization and impairment	**(282)**	**(558)**	**(468)**
Change in shadow accounting on VBI	291	(161)	(163)
Currency translation	(123)	180	(149)
Other changes	(33)	38	–
Net carrying value as at December 31	**5,050**	**2,623**	**3,123**
Gross carrying value as at December 31	8,130	5,760	5,474
Accumulated amortization and impairment	(2,686)	(2,444)	(1,821)
Shadow accounting on VBI	(394)	(694)	(530)

(a) Includes the amortization charge for the period, any losses of value and, exceptionally in 2004, capitalized interests relating to the United States and Japan.

In 2006, the €2,575 million increase in VBI following new subsidiaries' acquisitions consists of €2,327 million relating to Winterthur and €248 million relating to MLC Hong Kong. The €694 million increase in 2004 corresponded to the acquisition of MONY in the United States.

In 2005, amortization included an exceptional charge of €219 million in Japan, reflecting a change in future financial assumptions.

3.2.2.3 Amortisation of the fair value adjustment asset on non-life business

As indicated in Sections 2.2.1 and 2.2.3, the fair value adjustment to the gross undiscounted claims liabilities and unearned premium liability may be presented as a separate asset under IFRS and US GAAP. These assets should be amortised on a basis consistent with the corresponding gross undiscounted liability.

An illustrative example is provided below.

Star Insurance acquired the entire business of DirectAuto (a non-life insurer) assuming all of its insurance liabilities. The transaction qualified as a business combination and, therefore, the purchase method of accounting must be applied. DirectAuto's insurance liabilities at the time of the acquisition included:

- Unearned premium liability for unexpired insurance contracts in-force at the acquisition date that will expire in 18 months with a fair value of CU[1] 120 million, of which the expected profit margin is CU 20 million; and
- Unpaid claims liability for claims incurred including IBNR at the acquisition date with a fair value of CU 2,500 million, of which the fair value adjustment to the gross undiscounted claims liability amount is CU 140 million.

The management of Star Insurance has opted to present the acquired insurance liabilities using expanded presentation as permitted under both IFRS 4 and US GAAP, with gross undiscounted claims liability and unearned premium liability and a 'fair value adjustment' asset of CU 160 million that represents:

- The profit margin of CU 20 million included in the unearned premium liability - Star Insurance's accounting policies require deferral of any profit margin to be released on a straight-line basis. The unearned premium liability is earned through income on a straight-line basis.
- The fair value adjustment to the gross undiscounted unpaid claims liability of CU 140 million – Star Insurance's accounting policies require the recognition of unpaid claims liability on an undiscounted basis. The unpaid claims liability of DirectAuto is expected to be settled based on the following settlement pattern:

Expected settlement period	Annual settlement percentage
One year later	30%
Two years later	15%
Three years later	22%
Four years later	28%
Five or more years later	5%
Total unpaid claims liability	100%

In this example the straight-line basis would appear appropriate for the portion of the fair value adjustment asset that relates to the unearned premium liability (ie, the profit margin of CU 20 million) because it is subsequently earned on a straight-line basis.

However, the portion of the fair value adjustment asset associated with the gross undiscounted claims liability (ie the 140 million) should not be amortised on a straight line basis because it is not consistent with the measurement of the associated insurance liabilities. In other words, it should be amortised on a basis consistent with the liability's settlement pattern. In this case, Star Insurance should update the asset amortisation pattern at each reporting rate if the settlement pattern is expected to be materially different.

1 CU represents one local currency unit.

3.3 Practical considerations on post-acquisition financial reporting

3.3.1 Creation of a new infrastructure for group financial reporting

For the acquirer, a poorly planned integration process could introduce unforeseen post-acquisition challenges and escalating costs for some years, as well as having important consequences on the success of the transaction and the level of risks. This concern is even more acute in the insurance industry:

- **The acquirer should ensure that the group financial reporting infrastructure supports the acquired subsidiary's reporting capabilities:** The financial reporting systems of the acquirer and the acquired entity may not be initially compatible, which could result in the use of spreadsheets to bridge the gap between the group reporting database and the local reporting database at acquired entity level. The use of spreadsheets to link subsidiary reporting to group reporting systems should be a temporary measure. Depending on the extent of information needed for presentation and disclosure in an insurer's financial statements, this can be cumbersome and costly: consider the data requirements specific for invested assets, insurance contracts and IFRS-specific risk-related disclosures provided in the financial statements.
- **Insurers operate in a highly regulated environment and, therefore, can have multiple sets of records to maintain:** An acquisition imposes new demands on the acquired subsidiary which already has to provide its own separate financial information to its local tax authorities, the local insurance regulator, and its own separate financial statements under IFRS, US GAAP or some other GAAP. This can be a challenge, especially if the measurement basis of the assets and liabilities are not measured at fair value through the income statement. This is further described in Section 3.3.2. This may require new accounting and/or investment systems, more people, etc. The demands of these multiple sets of accounting records can be further compounded if the acquired entity has a different reporting date, or operates in a different language that leads to difficulties in fully understanding the acquirer's group reporting instructions distributed prior to each closing for consolidated reporting purposes.
- **Accounting and valuation systems and skilled resources at acquired entity:** Business combinations involving insurers can bring on a whole host of requirements for skilled resources that should not be underestimated and can prove to be costly, given the complexities in accounting and valuation associated with insurance business. These requirements can include (i) qualified accountants with knowledge and expertise in IFRS and/or US GAAP, (ii) valuation specialists to monitor ongoing amortisation patterns of amortising assets and to provide valuation assistance for testing goodwill for impairment, and (iii) actuaries for new financial reporting demands imposed by the group (such as embedded value reporting and other forms of reporting in which the acquired entity does not have previous experience).
- **Adequate internal control structures:** Numerous jurisdictions have regulations in place requiring the local entities to assess and report on their internal controls. An acquisition introduces new challenges because of new accounting and valuation systems, changes in resources and creation of new financial reporting bases for group reporting purposes. As a result, new internal control requirements, procedures and testing may need to be introduced. These internal control requirements may or may not be similar to requirements of the Sarbanes-Oxley Act (SOX) in the US. If the acquirer's group is subject to SOX, then two points should be noted: (i) the PPA is in the scope of SOX in the year of acquisition, and (ii) SOX exempts the controls over the post-acquisition results of the newly acquired company in the acquirer's management's report under Section 404 in the first year of acquisition only, however, this relief is removed for subsequent reporting periods.

… Some thoughts to take away …

Post-acquisition infrastructure and integration are important elements of the deal process which should be considered when looking at a prospective target, given the potential costs involved and the potential risk of financial reporting errors.

These challenges can be further heightened if the acquirer does not wholly own the acquired entity, which can impede the parent company's ability to control the subsidiary over the production of quality data according to group accounting policies under group reporting timetables.

Special requirements apply for entities that need to comply with SOX concerning the internal controls around the PPA and the post-acquisition results of the acquired entity.

3.3.2 Post-acquisition integration, multiple sets of accounting records

The acquired subsidiary may need to maintain more than one set of accounting records for its own local reporting and also for reporting to the parent company on consolidation. Some examples of issues that can arise with the use of multiple accounting records are presented below.

Accounting theme	Accounting by subsidiary for local purposes	Accounting by subsidiary for group reporting purposes[1]
Investments in investment funds supporting participating contracts	The fund may not be consolidated at subsidiary level but rather accounted for as a single investment.	The fund may be a group subsidiary and, therefore, the entity investing in it would need to consolidate the fund for group reporting purposes despite no consolidation for entity's separate financial statements.
Financial assets designated as available-for-sale	Records based on original cost when security was acquired originally by that entity. The original cost is used to determine the recognition of unrealised gains and losses in equity, impairment and the calculation of realised gains and losses on disposal.	Records based on the 'acquisition cost' from the acquirer's perspective in reference to the fair value at the business combination date. The PGAAP reference cost will be used to determine the recognition of unrealised gains and losses in equity, impairment and the calculation of realised gains and losses on disposal in future periods.
Financial assets measured at amortised cost such as held-to-maturity or loans & receivables	Effective interest-rate method based on original acquisition cost of the security.	Effective interest-rate method based on PGAAP reference cost, being the fair value at business combination date.
Real estate property at depreciable cost	Depreciation is calculated as a reduction of original cost paid by entity when property was acquired at origin.	Depreciation is calculated as a reduction of PGAAP reference cost, being the fair value at business combination date.

1 This could arise in two cases: (i) in circumstances where SEC 'push-down' accounting is required (see Section 2.5.5); or (ii) if the Group reporting entity requires the acquired subsidiary to perform the necessary adjustments that will form part of the consolidation adjustments for Group reporting purposes under IFRS and/or US GAAP.

Accounting theme	Accounting by subsidiary for local purposes	Accounting by subsidiary for group reporting purposes[1]
Acquired identifiable intangible assets	Not recorded unless SEC-style push-down accounting applied (see Section 2.5.5).	Recorded at fair value on business combination date and amortised over the life of each of the assets according to the expected economic benefits (usage) and estimated useful life. Foreign currency cumulative translation adjustments recorded.
Goodwill	Not recorded unless SEC-style push-down accounting applied (see Section 2.5.5).	Foreign currency cumulative translation adjustments recorded (regardless of whether 'push-down accounting' is applied or not – see Section 1.3.2).
Insurance contracts measured using locked-in assumptions[2]	Locked-in assumptions determined at contract inception.	Locked-in assumptions set at PGAAP business combination date.
VBI – discount rate and amortisation pattern	Assuming no SEC-style push-down accounting, the acquired entity may have its own VBI asset on its books from previous acquisitions it made: amortisation pattern may be based on emergence of distributable profits as determined by the subsidiary on a local insurance regulatory basis and may not necessarily include an accrual for interest (if US GAAP not used). The unwind of the discount along with the amortisation will be based on the local subsidiary perspective.	VBI asset of the subsidiary determined on its acquired business at business combination date that nullifies the existing VBI asset held by the subsidiary for its own previous acquisitions. Amortisation pattern could be based on another approach such as the emergence of distributable profits (of subsidiary) through application of group policies including an interest accrual (if US GAAP used).
Segment reporting	For listed subsidiaries that are required to report under either IFRS or US GAAP, disclosure could be from the perspective of the subsidiary.	Disclosure provided from group perspective. The segments and the segment data may not necessarily be on the same basis of reporting as used by the local acquired subsidiary.

The adjustments above could also affect the attribution to participation benefits and deferred taxes which will further complicate the accounting.

1 This could arise in two cases: (i) in circumstances where SEC 'push-down' accounting is required (see Section 2.5.5); or (ii) if the Group reporting entity requires the subsidiary to perform the necessary adjustments that will form part of the consolidation adjustments for Group reporting purposes under IFRS and/or US GAAP.

2 Commonly observed by insurers that use US FAS 60-type basis of measuring long-duration life and savings contracts

3.4 Some practical considerations for impairment testing

The following is a high level summary of points to consider in the post-acquisition period concerning impairment testing of goodwill, indefinite-life/finite life intangible assets, and the VBI asset involving an insurer. This is not intended to address the general implications concerning the identification, recognition and measurement of impairment as this, in it itself is a complicated subject.

3.4.1 General commentary on impairment testing

Goodwill impairment for acquisitions of subsidiaries

> Allocation of goodwill can impact the extent to which there is goodwill impairment (see Section 2.5.4).
>
> Companies should recognise that highly competitive deals which are heavily dependent upon synergies to justify the price put pressure on the acquirer to realise those synergies as soon as possible; otherwise, the acquirer could face an impairment charge.

Goodwill is not amortised but rather subject to an annual impairment test at the same date each year, or more frequently if events or changes in circumstances indicate that the asset might be impaired under IFRS or US GAAP. These events are commonly referred to as 'triggering events' (see Section 3.4.3). A goodwill impairment charge is not reversible even if included in interim financial statements.[1]

Impairment charges can be large and infrequent and, therefore, increase the risk of volatility in post-acquisition earnings of the acquirer; such changes are unlikely to appear in any forecasts or projections that can only add to this surprise.

Some important differences in the goodwill impairment test between IFRS and US GAAP, include:[2]

- IFRS one-step impairment test versus US GAAP two-step impairment test;
- IFRS use of cash-generating unit (CGU) versus US GAAP use of reporting unit (RU); and
- IFRS reference to 'recoverable amount' for CGU (based on the higher of the fair value less costs to sell or 'value in use') as compared to 'gross fair value' for the RU under US GAAP. Fair value versus 'value in use' is further described in section 3.4.2.

Goodwill impairment for acquisitions of associates

Under IFRS, the whole investment is tested for impairment under IAS 36 if there is objective evidence of impairment according to IAS 39. Under US GAAP impairment testing is based on whether the decline in value of the entire investment is other-than-temporary.[3] IFRS and US GAAP are similar in that the investee's goodwill is not subject to direct impairment testing by the investor.

1 IFRIC 10 'Interim Financial Reporting and Impairment' was recently issued by IFRIC and clarifies that an impairment loss recognised on goodwill in an interim period shall not be reversed in subsequent periods. This is consistent with US GAAP, as the reversal of an impairment loss is prohibited (US FAS 142 paragraph 15).

2 Goodwill impairment: under IFRS apply IAS 36 and under US GAAP apply US FAS 142.

3 Equity method goodwill impairment: Under IFRS, apply IAS 36 according to IAS 28 paragraph 33 and under US GAAP apply US APB 18 paragraph 19(h) according to US FAS 142 paragraph 40.

Impairment of the VBI (if recognised as a separate asset)

- **For insurance contracts:** Under IFRS, the VBI asset is tested for recoverability as part of the liability adequacy test for the insurance contract (IFRS 4, paragraph 15). Under US GAAP, the general testing for recoverability is addressed in
  US FAS 60.[1]
- **For DPF investment contracts:** Under IFRS, the VBI asset is tested for recoverability as part of the liability adequacy test for the insurance contract (IFRS 4, paragraph 15) even though some may be of the view that the testing should be in the context of IAS 36 (as IAS 36 text wording excludes only 'insurance contracts'). Under US GAAP,
  in practice some have analogised it to DAC accounting and have applied an impairment test similar to that used for DAC associated with insurance contracts.[2]
- **For non-DPF investment contracts:** Under IFRS, the asset concerned is not a VBI asset (see 'impairment of acquired intangible assets' below). Under US GAAP, in practice some have analogised it to DAC accounting (similar to treatment for 'DPF investment contracts' above).

Impairment of acquired intangible assets

Finite-life acquired intangible assets: Subject to an impairment test if certain triggering events occur. In addition, management is required to review the asset's useful life and amortisation pattern on an ongoing basis as described in Section 3.2.2.1.

Indefinite-life acquired intangible assets: Not amortised, but subject to impairment testing annually or when a triggering event occurs. Under IFRS, these assets are likely to be tested for impairment as part of a cash-generating unit (CGU). US GAAP requires indefinite-life intangible assets to be tested for impairment separate from the reporting entity, based on the fair value of the asset or its asset group.

Under IFRS, reversals of impairment losses on intangible assets are allowed under specific circumstances whereas under US GAAP such reversals are prohibited.

1 The VBI asset is addressed in US EITF 92-9. The FASB staff believes that the VBI asset is similar in nature to deferred policy acquisition costs (DAC) and, therefore, should be evaluated for impairment using the premium deficiency test in US FAS 60 and US FAS 97. Consequently, US FAS 142 and US FAS 144 do not apply to the amortisation and impairment of the VBI asset.

2 A finite-life intangible asset is required to be tested for impairment under US FAS 144 paragraph 15. However, US EITF 92-9 indicates that US FAS 144 does not apply to the VBI asset but rather should be tested for impairment based on reference to the premium deficiency test under US FAS 60/97. The premium deficiency test does not apply to investment contracts. There is no specific guidance concerning an impairment test for the VBI asset associated with investment contracts in US FAS 97, although some in practice apply one similar to DAC.

3.4.2 Multiple valuation methods for goodwill impairment testing

Goodwill impairment testing under IFRS is based on the recoverable amount of the cash-generating unit (CGU), being the higher of its fair value less costs to sell and its value in use. US GAAP goodwill impairment testing is based on a gross estimated fair value of the reporting unit (RU) and implied fair value attributable to goodwill.[1] In practice, depending on the facts and circumstances, the test will likely be performed at a lower level under IFRS than under US GAAP.

- **Fair value (US GAAP) or fair value less costs to sell (IFRS):** It is the amount obtainable on the sale of the unit (in which goodwill exists) in an arm's-length transaction between knowledgeable, willing parties other than in a forced liquidation. Both US GAAP and IFRS approaches are based on market participant assumptions. For IFRS the gross fair value is reduced for estimated costs of disposal.[2] Given the typical absence of a binding sale agreement (IAS 36) or an active market (IAS 36 or US FAS 142), the fair value will be determined based on some form of valuation technique (see Section 2.1).
- **Value in use based on entity-specific assumptions (IFRS only):** It is based on a present value technique that considers cash flow projections using entity-specific assumptions. It represents management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset, with greater weight given to external evidence. It should consider the most recent financial budgets/forecasts approved by management over a maximum period of five years, unless a longer period can be justified. It should exclude any estimated future cash inflows or outflows expected to arise from future restructurings or from improving or enhancing the asset's performance. The projections include future overheads that can be attributed directly, or allocated on a reasonable and consistent basis, to the use of the asset, and shall be based on assets in their current condition, not taking account of improvements or enhancements to the asset's performance. Therefore, no future cost savings and no enhancement capital expenditures are assumed. The projected cash outflows can include cost savings expected to arise from restructurings once committed, based on the most recent financial budgets and forecasts approved by management, so long as the estimated future costs of such outflows are included in a qualifying IAS 37 provision.[3]

The principal difference between the 'fair value' method and the 'value in use' method is that fair value will be based on externally sourced inputs or, in the absence of those inputs, assumptions that would be used by a market participant whereas 'value in use' will be measured using assumptions based on management's views that may not necessarily be similar to that observed in the marketplace.

As highlighted in Chapter Two, there is limited market data for insurance contracts and also acquired intangible assets specific to insurers. However, when valuing an entity, or in this case a unit (in which goodwill exists), more reference information is available in the marketplace for various reasons, including the fact that insurers are continually seeking to demonstrate the long-term value of their business to financial analysts and investors in general with performance measures such as embedded value.

The types of valuation techniques that can be observed with insurers may be a mix of income approach and market approaches. These techniques include, but are not limited to, the following:

- **Embedded value plus a multiple of new business contribution (an appraisal value):** If the embedded value does not take account of a full fair value measurement then such fair value adjustments should be included in this model;
- **Multiple of embedded value**: Fair value derived from multiples of embedded value using estimated price to embedded value ratios;

1 IAS 36 paragraph 6 and US FAS 142 paragraph 15.

2 IAS 36 paragraph 5 (a) Costs of disposal include legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale, but would not include employee termination benefits and certain other restructuring costs as they are not considered direct incremental costs to dispose of the asset.

3 IAS 36 paragraphs 33, 34, 44 and 47.

- **Price to earnings basis**: Fair value derived using multiples of earnings using estimated Price to Earnings ratios;
- **Price to book basis:** Fair value derived using multiples of book based on CGU's/operating segments' carrying value; or
- **Other valuation methodologies:** Methodologies that may be used to price similar transactions in the insurance industry sector.

... Some thoughts on valuations used for goodwill impairment testing ...

- **Special comment on 'value in use'.** If the insurer applies a 'value in use' measurement, then the extent to which an insurer can project beyond five years needs to be considered. This can be easier to demonstrate for profit emergence on an existing book of business in force, but may be much more difficult to demonstrate for the new business contribution included in the valuation. A steady or declining growth rate for subsequent years is appropriate, unless an increasing rate can be justified. This growth rate should not exceed the long-term average growth rate for the products, industries, or country or countries in which the entity operates, or for the market in which the asset is used, unless the insurer has compelling evidence that a higher rate can be justified. In addition, as indicated by the IASB, the growth rate could be zero or even negative.[1]
- **Modelling fair value for the measurement of units.** There is no unique valuation methodology or one set of assumptions that should be used. In other words, the valuation of the CGU/RU is not an exact science. Therefore, it may be useful to run different scenarios in the valuation modelling and to compare them across a series of different valuation methods to ensure that the amounts determined are within a reasonable range.
- **Consideration of market capitalisation.** SEC registrants may also consider the market capitalisation as a good litmus test. The FASB and the SEC have indicated that the market price of an individual equity security (and thus the market capitalisation of a reporting unit with publicly traded equity securities) may not be representative of the fair value of the reporting unit as a whole because of the potential existence of a control premium (ie, the premium an acquiring entity is willing to pay for a controlling interest versus the amount an investor would be willing to pay for a non-controlling interest) which may cause the fair value of a reporting unit to exceed its market capitalisation. However, there is a linkage between market capitalisation and fair value. In this context, even if the sum of the fair values of an entity's reporting units does not necessarily equal the entity's market capitalisation, a quick reference to market capitalisation may be used to test the soundness of the sum of fair values attributed to all CGUs/RUs and could indicate the reasonableness of the measures determined for goodwill impairment testing.
- **Issues concerning valuation.** The valuations used in the impairment testing should be performed with all necessary parties involved including (i) the valuation specialists and actuaries, who will review of the valuation methods applied, assumptions used, and general observations in the marketplace, (ii) management, who will determine the valuation methods, set the assumptions, and provide the information necessary to support the valuation assertions, (iii) the accountants who will ensure that recognition and measurement is in accordance with the financial reporting requirements, and (iv) the auditors, who will provide an audit opinion on the financial statements that will include the financial output of those valuations.

1 IAS 36 paragraphs 33(c) and 36.

3.4.3 Types of triggering events specific to insurance operations

Under IFRS and US GAAP goodwill is subject to annual impairment testing unless there are events that arise in the interim period that indicate a possible risk of impairment, at which time an interim impairment testing should be performed. This is important given that a goodwill impairment charge recorded at an interim reporting date or at a year-end reporting date is not reversible (see Section 3.4.1).

There are a number of possible triggering events. Triggering events are subjective in nature and depend on the facts and circumstances specific to the business operations. Consideration must be given to the frequency and severity of such events. Assessing whether a triggering event has occurred requires judgement.

Examples of factors specific to insurers that could indicate possible triggering events are provided below. The list is not meant to be exhaustive.

- **A change in management strategy** such as to curtail a business or activity that is important to one or a group of units.
- A significant and/or prolonged decrease in **performance indicators** such as embedded value.
- **Adverse change in local insurance regulations** that would impact future profitability of a unit with minimal opportunity of a medium-term improvement within the next three to five years. Possible examples include a cap on the operating costs that cannot be passed through as charges to the policyholder, or an unexpected increase in solvency requirements.
- **Adverse change in legal environment.** Court decisions can affect the future cost of claims which could in turn have an adverse impact on the profitability of a unit's insurance business with minimal scope for a medium-term improvement. Examples of changes might include a government, court and/or judicial decision to increase the cost of allowable bodily injury claims to protect the suffered claimants or a decision to cap current and future increases in premium rates to protect consumer interests (ie, the extent to which costs can be recuperated out of future premiums).
- **Adverse change in consumer demand for products and services offered.** Changes in socio-economic factors and/or demographic shifts that could alter general policyholder behaviour which adversely affect the insurer due to its inability to respond to consumer market changes without a fundamental change in operations.
- **A general market downturn in the industry sector (recent merger and acquisition activity).** Recent transactions within the industry could indicate that the business is not as valuable as it once was thought: (i) the pricing of recent transactions could put into question the validity of 'current market assumptions' being used internally in determining fair value, or (ii) the consolidation in the sector arising from the M&A activity could adversely impact the entity's market position or market share that could likely harm its ability to increase business volumes or margins over the near-to long term as expected.

- **Significant changes (actual, ongoing or anticipated) in financial variables like interest rates and equity prices.** Such changes could adversely affect the products and services offered by the unit that cannot be changed without a fundamental change in operations: (i) the unit offers unit-linked business but there is a general market swing to financial protection products, which are products not supported by the unit, (ii) significant decreases in the interest rates which could challenge the insurer's ability to meet future obligations relating to interest-rate guarantees offered on existing products, (iii) a significant decrease in asset yields which challenge the unit's ability to support the future policy obligations because of increasing claims ratios/combined ratios/ over declaration of policyholder participating bonuses where a decrease could undermine ability to compete against other third-party insurers.

... Some thoughts to take away ...

The existence of any one factor may not necessarily indicate that a triggering event has in fact occurred, but it can serve as a prompt to assess whether a triggering event has occurred requiring an interim impairment test.

Companies should have a policy that supports the basis by which management monitors business activities that could indicate when triggering events have occurred.

Management should look out for circumstances in which the assumptions may not necessarily be coherent with trends observed in the marketplace concerning items such as new business contribution, surrender rates, investment return, etc.

Epilogue

Purchase accounting will evolve: A look into the future

Purchase accounting for insurers will continue to evolve in the upcoming years. Not only will views be expressed by regulators on current developing practices but there will also be IFRS-US GAAP developments including, but not limited to:

1 IASB-FASB convergence project on Business Combinations Phase II

2 IASB-FASB convergence project on Fair Value Measurement

3 IASB Insurance Contracts Phase II project

1. IASB-FASB convergence project on Business Combinations Phase II

IASB and FASB have a joint project on Business Combinations referred by many as Business Combinations Phase II (or BC II). In this phase of the project, the existing guidance for applying purchase method of accounting, being the acquisition method, was to be reconsidered. This joint project is the first in what is expected to be a series of converged standards issued jointly by the FASB and IASB for the global community. Both US FAS 141 and IFRS 3 will be revised.

The FASB's version was published on 4 December 2007 as US FAS 141 (revised 2007) 'Business Combinations' (US FAS 141R) and can be found on their website (www.fasb.org). The IASB expects to issue IFRS 3 (revised) 'Business Combinations' (IFRS 3R) in early January 2008.

US FAS 141R will be effective for acquisitions that close beginning in 2009. Early adoption is prohibited. IFRS 3R will be effective for acquisitions from 1 July 2009 but early adoption will be permitted.

There are some significant changes to how business acquisitions will be accounted for and will impact financial statements both on the acquisition date and in subsequent periods.

More transactions and events will qualify as business combinations and will be accounted for at fair value under the new standard, including transactions involving mutual entities and business combinations achieved by contract alone. Currently transactions impacting mutual insurers are scoped out of IFRS 3 and subject to a deferral under US FAS 141 (this will impact information provided currently in Section 1.5).

The revised standards continue the movement toward the greater use of fair values in financial reporting. All business combinations will result in all assets and liabilities of the acquired business being recorded at their fair value, with limited exceptions (this will impact information provided currently in Section 2.4 and for contingencies Section 3.2.1).

There are also other important implications including the determination of measurement date and the accounting for contingent consideration, contingencies, business combination acquisition costs, restructuring costs, income taxes, amongst other items.

With limited exceptions, the principles in each standard are the same. However, certain differences will remain, which are described under Appendix G to US FAS 141R (this will impact IFRS-US GAAP differences as currently described in Section 1.7).

For further information concerning BC II, a summary of the key provisions of the standards and their implications has been prepared in an article issued by PwC entitled "PwC Business Combinations Briefing Document" which can be found on our website www.cfodirect.pwc.com along with "PwC Business Combinations Executive Overview" to provide facts and insights to senior executives and directors.

Two PwC Datalines will be issued shortly with the objective to provide additional insight. These datalines will also be available from our website.

A detailed PwC guide containing an analysis of US FAS 141R and IFRS 3R will be issued in mid-2008.

1 IAS 38 paragraph 38.

2. US FAS 157 'Fair Value Measurements': Future Implications

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 'Fair Value Measurements' (US FAS 157). It will be effective for financial statements issued for fiscal years beginning after 15 November 2007 and interim periods within those fiscal years (ie, 1 January 2008 for calendar year-end reporting entities) unless early adopted.

US FAS 157 establishes a single definition of fair value and addresses how fair value should be measured when a fair value measure is required for recognition or disclosure purposes under US GAAP.

The US FAS 157 definition of fair value is based on an exit price, being 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.

The fair value model is in reference to a hypothetical market-based transaction. There is an assumption that the transaction occurs in the principal market used to exchange the asset or liability (the market used by the reporting entity with the greatest volume and level of activity). In the absence of a principal market, the most advantageous market is used (the market in which the reporting entity could maximise the amount that would be received for the asset or minimise the amount that would be paid to transfer the liability). The fair value measure assumes the highest and best use of an asset by market participants, even if the intended use of the asset by the reporting entity is different.[1]

The US FAS 157 fair value model describes three valuation techniques to measure fair value without expressing a preference for any one particular technique. The first technique is referred to as a market approach, involving identical or comparable assets or liabilities. The second technique is an income approach, based on discounted cash flows using market-based assumptions with risk reflected either in the cash flow margins or in a risk-adjusted discount rate. The third technique is a replacement cost approach.

The inputs to the valuation techniques represent the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. These inputs may be observable (based on market data obtained from sources independent of the reporting entity) or unobservable (reflects the reporting entity's own assumptions about the assumptions market participants would use in the absence of market data). US FAS 157 establishes a fair value hierarchy that prioritises the inputs to the valuation techniques placing greater weight on observable inputs as compared to unobservable inputs. The fair value hierarchy is described below.[2]

1 Discussion of principal (or most advantageous) markets and application to assets is addressed in US FAS 157 paragraph 8-9 and 12.

2 Information concerning the US FAS 157 inputs to the valuation technique and fair value hierarchy can be found in US FAS 157 paragraphs 21-31.

US FAS 157 fair value hierarchy:

Level one (highest level):	Quoted prices in active markets are the best evidence of fair value.
Level two (medium level):	Quoted prices on similar transactions, or an exit price determined using valuation techniques based on market participant assumptions, in other words, market data from sources independent from the entity *(observable inputs).*
Level three (lowest level):	Exit price is determined in reference to unobservable inputs reflecting the reporting entity's own assumptions about the assumptions that market participants would use. The inputs are based on the best information available, which might include the reporting entity's own data.

The level determined for a particular asset or liability is the lowest level of significant input: for example, a discounted cash flow technique could either fall in level two or level three depending on whether the lowest level of significant input used to measure the fair value in its entirety is observable or unobservable.

US FAS 157 also covers certain other topics that are not highlighted here as they are not necessarily specific to the day one determination of fair value in the PPA, including (i) Day one gains and losses, (ii) fair value of liabilities including changes in credit risk, and (iii) the treatment of transaction costs. Further information concerning fair value measurement can be found in the PwC US Datalines 2006-25 and 2007-12 available on www.pwccomperio.com and www.cfodirect.pwc.com.

In the context of IFRS, the IASB acknowledged a need for clear, consistent guidance on fair value measurement as required in existing IFRSs especially in the context of business combinations. Consequently, the IASB added a Fair Value Measurement project to its agenda. Because of a need for consistent guidance on measuring fair value in IFRSs and for increased convergence with US GAAP, the IASB decided to use US FAS 157 as the starting point for its deliberations. A discussion paper was published by the Board in November 2006. The Board received 136 comment letters in response to the invitation to comment. Responses from the comment letters and feedback from upcoming roundtable meetings planned during the first half of 2008 will be used by the IASB to develop an IFRS exposure draft on fair value measurement. The IASB aims to publish the exposure draft in the first half of 2009.

Consequently, the new US GAAP basis for defining and measuring fair value under US FAS 157, effective for calendar year-end reporting entities from 1 January 2008, will result in changes to IFRS-US GAAP differences especially in the accounting for business combinations involving insurers as described currently in Section 1.7. The extent to which these differences persist will depend on the timing and outcome of the IASB's project on fair value measurement and any further evolutions under US GAAP.

… US FAS 157 continues to evolve …

On 14 November 2007, the FASB announced a one year deferral for the implementation of US FAS 157 for nonfinancial assets and liabilities unless carried at fair value on a recurring basis in financial statements.

This deferral does not apply to financial assets and liabilities and any other assets and liabilities that are carried at fair value on a recurring basis in financial statements. As a result, US FAS 157 becomes effective as originally scheduled in accounting for the financial assets and liabilities of financial institutions.

At the time of writing, the exposure draft had not yet been issued for comment on this partial deferral.

3. IASB Insurance Contracts Phase II project

The IASB has a project, generally referred to as Insurance Contracts Phase II, to develop an accounting standard for insurance contracts including discretionary participating features (DPF) which exist in insurance and investment contracts. This project culminated in the publication of a Discussion Paper ('the Phase II Discussion Paper') on the IASB's Preliminary Views on Insurance Contracts in May 2007 concerning the accounting for insurance and reinsurance contracts of insurers. The comment period closed on 16 November 2007. In conjunction with the Phase II Discussion Paper, the Staff also made publicly available frequently asked questions concerning service margins in October 2007. Both the Phase II Discussion Paper and the frequently asked questions are available on the IASB's website (www.iasb.org).

The IASB's preferred measurement model for insurance contracts under Phase II, referred to as the 'current exit value' model, is based on the amount the insurer would expect to pay today if it transferred all of its remaining contractual rights and obligations immediately to another entity (ie, an exit price). The model has three important features: (i) the model is based on current information of unbiased probability-weighted estimated cash flows, (ii) cash flows should reflect the time value of money (ie, should be discounted), and (iii) the use of observable market inputs in determining explicit margins for bearing the risk of uncertainties in cash flows (risk margin) and for providing other services such as investment management throughout the duration of the contract (service margin). As there are no locked-in assumptions, there is no need for loss recognition testing. As the margins are based on market observable inputs, there is a possibility of day one gains or losses arising from the difference between the premium received by the insurer and the current exit value determined on day one.

As indicated in Phase II Discussion Paper paragraph 104, the IASB has not yet reached a final conclusion on whether the definition of fair value (in its Fair Value Measurements project, see Epilogue 2) is the same as current exit value as defined in the Phase II Discussion Paper, as that would pre-empt the IASB's Fair Value Measurements project. However, the Board has indicated that it has not yet identified significant differences between them.

The conclusions ultimately reached by the Board concerning current exit value as compared to fair value could have important implications for the accounting of business combinations and also portfolio transfers that do not qualify as a business combination. On this point, the IASB provided some comment on this topic in paragraph 167-172 of the Phase II Discussion Paper including whether reassessment of contract classification is required at acquisition date and thoughts on the treatment of excess when contracts are acquired in a portfolio transfer that does not qualify as a business combination. The Board also indicated that if any significant difference remains between the current exit value and fair value, then it may be necessary to consider retaining expanded presentation that is permitted currently under IFRS 4 (Phase II Discussion Paper paragraph 169).

The Board expects to begin analysing the comment letters received in the first quarter of 2008. The Exposure Draft is currently expected to be published in 2009. The issuance of a final standard is not expected before 2010.

The IASB is still some way off adopting a final position on Insurance Contracts Phase II and Fair Value Measurements. If it turns out that the two do not meet up then, we would hope that IASB would provide some guidance on how to measure the gap between fair value and current exit value for purposes of the PPA, in other words, guidance on what supplemental or independent calculations would be required to produce fair value data.

Glossary

Term	Description
Business	**IFRS:** An integrated set of activities and assets are conducted and managed for the purpose of providing a return to investors, or lowers costs or economic benefits directly and proportionately to policyholders and participants (IFRS 3 Appendix A). **US GAAP:** The definition of a business is in the context of a self-sustaining integrated set of activities with assets conducted and managed to provide a return to investors (US FAS 141 paragraph 9). More specifically, it refers to guidance provided in paragraph 6 of US EITF Issue No. 98-3 'Determining whether a non-monetary transaction involves receipt of productive assets or of a business'. US EITF 98-3 indicates that a business consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to generate revenues. For a transferred set of activities and assets to be a business, it must contain all of the inputs and processes necessary for it to continue to conduct normal operations after the transferred set is separated from the transferrer, which includes the ability to sustain a revenue stream by providing its outputs to customers. Outputs are in reference to the ability to obtain access to the customers that purchase the outputs from the transferred set. A transferred set of activities fails to meet the definition of a business if it excludes one or more of the three items (inputs, processes, outputs). However, if excluded items are minor (based on degree of difficulty and level of investment needed), then the transferring set of activities could still qualify as a business.
Business combination	A transaction that brings together separate entities or businesses into one reporting entity whereby the acquirer obtains the control of the acquiree. The focus is on the transfer of control of a 'business' from one party to another. **IFRS:** The bringing together of separate entities or businesses into one reporting entity (IFRS 3 Appendix A). **US GAAP:** A business combination occurs when an entity acquires net assets that constitute a business or acquires equity interests of one or more other entities and obtains control over that entity or entities (US FAS 141 paragraph 9).
Change in estimate	**IFRS:** An adjustment of the carrying amount of an asset or liability, or the amount of periodic consumption of an asset arising from new information or new developments. It is not a correction of an error (IAS 8 paragraph 5). **US GAAP:** A change that has the effect of adjusting the carrying amount of an existing asset or liability or altering the subsequent accounting for existing assets or liabilities. Changes in accounting estimates arise from new information (US FAS 154 paragraph 2(d)). *IFRS and US GAAP are similar.*[1]
Contributory Asset Charges	When valuing an intangible asset under the Income Approach, it is necessary to determine the present value of net cash flows attributable to the subject intangible asset being value. The net cash flows attributable to the intangible asset being value are those in excess of the fair returns on all the assets that are necessary to the realisation of the cash flows. Contributory assets are tangible and intangible assets used in production of income or cash flow associated with an intangible asset being valued. Contributory asset charges are based in reference to the fair value of the contributing assets (for example, fixed assets) to determine a fair value returns, which represent the contribution of other assets to the overall value realised for the purchased intangible asset. The contributory asset charge is deducted from the cash flows generated by the purchased intangible asset in order to arrive at a fair value for the purchased intangible asset. In other words, this procedure treats the contributory assets as being leased from a third party to the extent necessary to generate cash flows.

1 PwC publication 'Similarities and Differences – A comparison of IFRS and US GAAP (October 2007).
2 Idem.

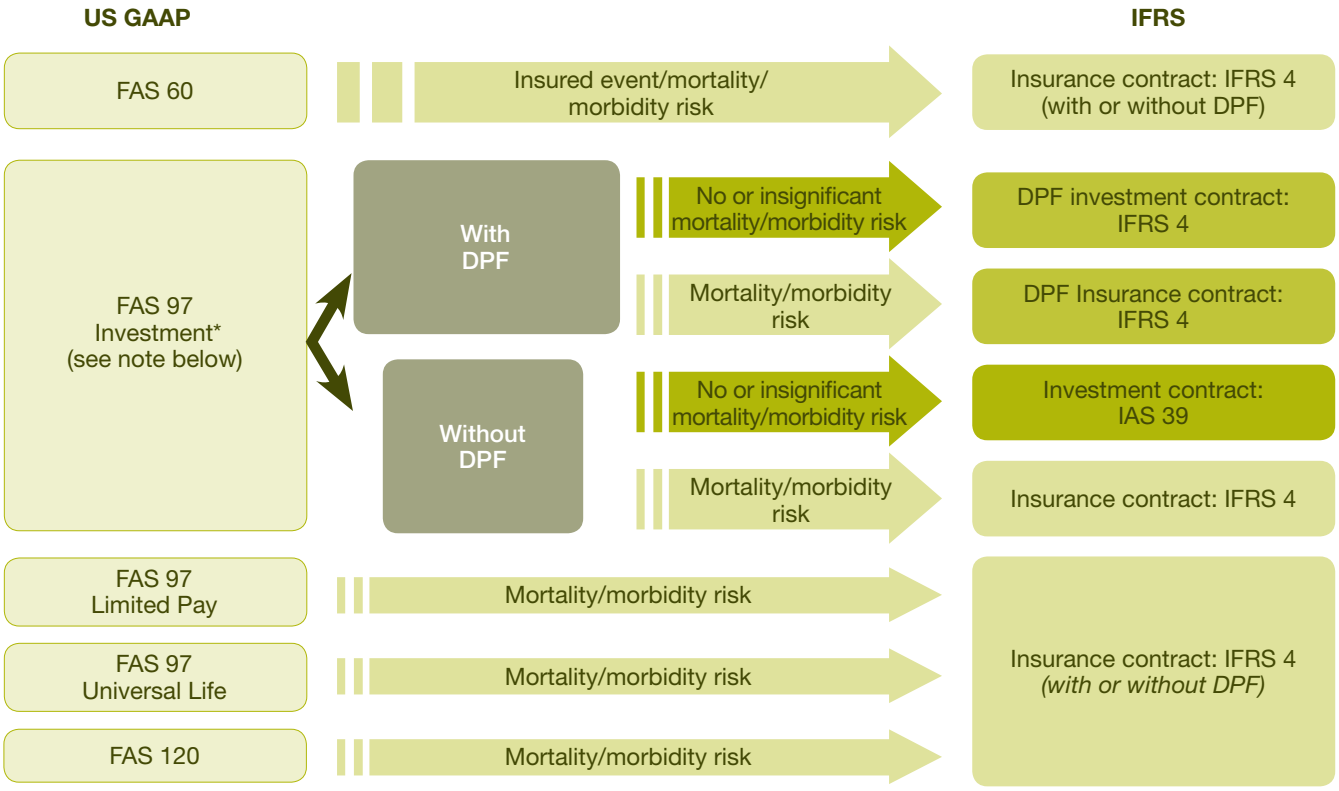
Term	Description
Correction of an error in previously issued financial statements	**IFRS:** Referred to as 'prior period errors', which are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that was available at the time the financial statements were authorised for issue and could reasonably be expected to have been obtained and taken into account in the preparation of those financial statements (IAS 8 paragraph 5). **US GAAP:** An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in application of GAAP, or oversight or misuse of facts that existed at the time the financial statements were prepared (US FAS 154 paragraph 2(h)). *IFRS and US GAAP are similar, reported as a prior-period adjustment and restatement of comparatives is mandatory.*[2]
Customer relationship	A relationship whereby the entity has information about the customer and has regular contact with the customer, and the customer has the ability to make direct contact with the entity (for instance because the company owns a list of names and telephone numbers or addresses). The customer has the ability to make direct contact with the entity and vice versa. In other words, if the selling of the business establishes a direct link with the customer, then the intangible to be valued should be a customer relationship intangible. **IFRS:** Provided through Illustrative Examples under IFRS 3. **US GAAP:** A customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer and (b) the customer has the ability to make direct contact with the entity. Relationships may arise from contracts (such as supplier contracts and service contracts). However, customer relationships may arise through means other than contracts, such as through regular contact by sales or service representatives (US FAS 141 Appendix F Glossary). Further guidance can be found in US EITF 02-17 'Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination'.
Discretionary participating feature (DPF) *(IFRS only)*	This is a term defined in IFRS 4 Appendix A as a contractual right to receive, as a supplement to guaranteed benefits, additional benefits: (a) that are likely to be a significant portion of the total contractual benefits; (b) whose amount or timing is contractually at the discretion of the issuer; and (c) that are contractually based on: (i) the performance of a specified pool of contracts or a specified type of contract; (ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or (iii) the profit or loss of the company, fund or other entity that issues the contract. This is not a term used under US GAAP.
Distribution channel	This is not a term defined under IFRS or US GAAP. It is a customer relationship between the acquired insurer and the customer that is principally with a distributor (eg banks, brokers, independent financial advisers, agents, etc.). In other words, if the selling of the business establishes a direct link with the distributor to access the customer, then the intangible to be valued should be the distribution channel. For example, the acquisition of an insurance business that has a strong third-party bank distribution network.
Fair value	**IFRS:** The amount at which an asset or liability can be acquired or settled between knowledgeable, willing parties in an arm's-length transaction, that is, other than in a forced or liquidation sale (IFRS 3 Appendix A Defined Terms). It can be viewed as a hypothetical transaction between a willing buyer and a willing seller for an amount that would be determined by a market participant. **US GAAP:** The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale (US FAS 141 Appendix F Glossary). *This US GAAP definition of fair value is the current definition at the time of writing and, therefore, does not take account of US FAS 157 'Fair Value Measurements' which is effective for fiscal years beginning after 15 November 2007 (i.e. 1 January 2008 for calendar year-end reporting entities) unless adopted early. Further information concerning fair value under US FAS 157 can be found in the Epilogue.*

Term	Description
Goodwill	It is the excess or deficiency of purchase price over the fair value of the individual assets acquired and liabilities assumed. It is a residual value. **IFRS:** Measured at its cost, being the excess of the cost of the business combination over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities (IFRS 3 paragraph 51). **US GAAP:** The excess of the cost of an acquired entity over the net of the amounts assigned to assets acquired and liabilities assumed. The amount recognised as goodwill includes acquired intangible assets that do not meet the criteria in paragraph 39 for recognition as assets apart from goodwill (US FAS 141 Appendix F Glossary).
Health insurance	A general term used to refer to insurance operations that write **insurance contracts** with significant insurance risk (notably morbidity risk) but may also include health contracts that may not necessarily have insurance risk like certain group contracts.
Life insurance	A general term used to refer to insurance operations that write **insurance contracts** with significant insurance risk (notably mortality risk) **and or** investment contracts or group life contracts that do not have significant insurance risk. Life insurance business may be also referred to as 'life & savings insurance business'.
Loss ratio time series	A loss ratio is the ratio of incurred losses plus loss adjustment expenses divided by earned premiums. It is a term used principally in the context of non-life business. A time series is a set of observations of a quantity (a variable) over a period of time (eg, share prices and similar financial and economic variables). Therefore, a loss ratio time series is a set of loss ratios plotted against time for a specified entity, geographical sector, market sector, etc.
Market participant and/or marketplace participant	It is used in reference to the assumptions used to determine fair value through the use of a valuation technique, in the absence of quoted market prices in an active market. It is based on a hypothetical transaction between a knowledgeable and willing buyer and seller in an arm's-length transaction. The common term under IFRS is 'market participant' whereas under US GAAP the equivalent term used is 'marketplace participant'.
Mutual entity	An entity that is not investor-owned whereby the economic benefits flow directly to its owners, members or participants, possibly on a proportionate basis.
Non-life insurance	Non-life insurance business may be also referred to as 'property and casualty insurance business' or 'general insurance'.
Purchase price allocation (PPA)	One element of the purchase method of accounting is the purchase price allocation (or PPA). The PPA refers to the process performed by the acquirer to allocate the cost of the acquisition to the individual assets acquired and liabilities and contingent liabilities assumed based on their fair values determined at the acquisition date (IFRS 3 paragraph 36 and US FAS 141 paragraph 35). *The allocation exercise may be referred to by some as the opening balance sheet exercise, Purchase GAAP (PGAAP), or purchase price allocation (PPA), among other terms.* *For purposes of this document, we have abbreviated 'purchase price allocation' to 'PPA', however, this is not a recognised abbreviation found in authoritative literature.*
Run-off	Continuation of the activities of the business is limited to the renewal of existing policies. No new policies will be written.
Value of business in force acquired (VBI)	VBI is determined based on a calculation of present value of future profits to emerge on acquired in-force block of contracts according to the Indirect Method described in Section 2.2. Under this method, the VBI along with the IFRS/US GAAP record value of the contract liability and an associated deferred tax item would approximate the fair value of acquired contract. It could be positive (an asset) or negative (an additional liability), see sections 2.2.2.2 and 2.2.2.3, respectively. VBI is also commonly referred to as Value of Business Acquired (VOBA), Present Value of Future Profits (PVFP), Present Value of In-Force (PVIF), Value of In Force (VIF), and other similar acronyms can also be found.

Appendices

Appendix I:
Relationship between US GAAP and IFRS contract classification

Appendix I: Relationship between US GAAP and IFRS contract classification



US FAS 97 investment contracts may not necessarily be treated as investment contracts under IFRS. The terms and conditions need to be understood in order to verify the appropriate contract classification under IFRS and US GAAP. Some examples of differences that can arise are noted below.

- **Evaluation of annuity products under US GAAP versus IFRS:** Certain contracts offer to the policyholder a variable annuity (an asset accumulation contract) which at annuitisation (retirement date) can, at the choice of the policyholder, be either (i) converted into a life contingent payout annuity, or (ii) policyholder can take lump sum and leave to go to another provider. Under US FAS 97 these are treated as two separate contracts (US FAS 97 paragraph 7) whereby the variable annuity is treated as a US FAS 97 investment contract if there is no or insignificant mortality risk with no consideration of the payout annuity phase until annuitisation. However, in our view, under IFRS the variable annuity contract could qualify as an insurance contract at inception if there is constraint imposed on mortality and guarantees in the contract.
- **Contract offers a DPF:** If the contract has no or insignificant mortality risk, the contract is a US FAS 97 investment contract. Under IFRS, because of the IASB dilemma with respect to the recognition and measurement of contracts containing a DPF, such contracts are recognised and measured in IFRS 4 until Phase II is implemented.
- **The de minimus test for insurance risk under US SOP 03-1 is more restrictive than the IFRS 4 test based on one plausible scenario even if remote:** This is best discussed through an example. Some insurers can offer a 'pure endowment' contract that only pays 110% of the unit balance on death during the first half of the contract term and 100% thereafter. They fail the significance test in US GAAP SOP 03-1, as paragraph 25 indicates that the present value of the expected extra 10% paid on death is very insignificant compared to the present value of all the other charges (expense and asset management charges). However under IFRS this could be judged to be a significant enough change: the payments on death could occur in a scenario with commercial substance, in other words, death could occur during the first half of the contract period (IFRS 4 paragraph B23).

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We are grateful for the efforts of the partners and staff who have assisted in the production of this publication. In particular, we would like to thank: Jeannine Flower; Anne-Lise Vivier, the support of Ian Dilks, Ian Coleman and Gordon Ireland; and the contribution made by the editorial board including Francesco Nagari, Caroline Woodward, Donald Doran, Jack LaGue, Nick Rea, Albertha Charles, Sam Gutterman, Paul Truijens.

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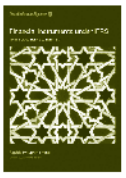
PricewaterhouseCoopers' IFRS and corporate governance publications and tools 2007

IFRS technical publications

IFRS Manual of Accounting 2008
Provides expert practical guidance on how groups should prepare their consolidated financial statements in accordance with IFRS. Comprehensive publication including hundreds of worked examples, extracts from company reports and model financial statements.

Adopting IFRS – A step-by-step illustration of the transition to IFRS
Illustrates the steps involved in preparing the first IFRS financial statements. It takes into account the effect on IFRS 1 of the standards issued up to and including March 2004.



Financial instruments under IFRS
High-level summary of the revised financial instruments standards issued in December 2003, updated to reflect IFRS 7 in September 2006. For existing IFRS preparers and first-time adopters.

Financial Reporting in Hyperinflationary Economies – Understanding IAS 29
2006 update (reflecting impact of IFRIC 7) of a guide for entities applying IAS 29. Provides an overview of the standard's concepts, descriptions of the procedures and an illustrative example of its application.

IFRS 3R: Impact on earnings – the crucial Q&A for decision-makers
Guide aimed at finance directors, financial controllers and deal-makers, providing background to the standard, impact on the financial statements and business, and summary differences with US GAAP.

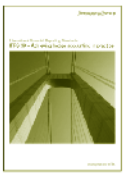
IFRS Disclosure checklist 2007
Outlines the disclosures required by all IFRSs published up to September 2006.

IFRS Measurement Checklist 2006
Outlines the measurement bases required by all IFRSs published up to September 2006.

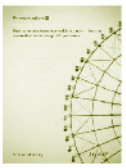
IFRS for SMEs (proposals) – Pocket Guide 2007
Provides a summary of the recognition and measurement requirements in the proposed 'IFRS for Small and Medium-Sized Entities' published by the International Accounting Standards Board in February 2007.

IFRS Pocket Guide 2006
Provides a summary of the IFRS recognition and measurement requirements, including currencies, assets, liabilities, equity, income, expenses, business combinations and interim financial statements.

IFRS News
Monthly newsletter focusing on the business implications of the IASB's proposals and new standards.



IAS 39 – Achieving hedge accounting in practice
Covers in detail the practical issues in achieving hedge accounting under IAS 39. It provides answers to frequently asked questions and step-by-step illustrations of how to apply common hedging strategies.



Illustrative condensed consolidated interim financial information – for existing preparers
Illustrative information, prepared in accordance with IAS 34, for a fictional existing IFRS preparer.
Includes a disclosure checklist and IAS 34 application guidance. Reflects standards issued up to 31 May 2006.

Illustrative Consolidated Financial Statements

- Banking, 2006
- Corporate, 2007
- Insurance, 2006
- Investment funds, 2006
- Investment property, 2006

Realistic sets of financial statements – for existing IFRS preparers in the above sectors – illustrating the required disclosure and presentation.

Illustrative Interim Consolidated Financial Statements for First-time Adopters – 2005
Realistic set of interim IFRS financial statements for first-time adopters. The financial statements for the six months ended June 2005 illustrate the disclosure and presentation required by all IFRSs published up to and including December 2004.

Share-based Payment – a practical guide to applying IFRS 2
Assesses the impact of the new standard, looking at the requirements and providing a step-by-step illustration of how to account for share-based payment transactions.

SIC-12 and FIN 46R – The Substance of Control
Helps those working with special purpose entities to identify the differences between US GAAP and IFRS in this area, including examples of transactions and structures that may be impacted by the guidance.

Similarities and Differences – a comparison of IFRS and US GAAP
Presents the key similarities and differences between IFRS and US GAAP, focusing on the differences commonly found in practice. It takes into account all standards published up to August 2007.

Understanding financial instruments – A guide to IAS 32, IAS 39 and IFRS 7
Comprehensive guidance on all aspects of the requirements for financial instruments accounting. Detailed explanations illustrated through worked examples and extracts from company reports.

PricewaterhouseCoopers' IFRS and corporate governance publications and tools 2007

IFRS surveys

Presentation of income measures
Trends in use and presentation of non-GAAP income measures in IFRS financial statements.

IFRS: The European investors' view
Impact of IFRS reporting on fund managers' perceptions of value and their investment decisions.

Business review – has it made a difference?
Survey of the FTSE 350 companies' narrative reporting practices. Relevant globally to companies seeking to benchmark against large UK companies.

IFRS market issues

IFRS 7: Ready or not
Key issues and disclosure requirements.

IFRS 7: Potential impact of market risks
Examples of how market risks can be calculated.

IFRS transition case studies
Companies in several industries share their experiences in making the change to IFRS. Orders for these flyers should be placed at global.ifrs.publications@uk.pwc.com

IFRS for SMEs – Is it relevant for your business?
It outlines why some unlisted SMEs have already made the change to IFRS and illustrates what might be involved in a conversion process.

Making the change to IFRS
This 12-page brochure provides a high-level overview of the key issues that companies need to consider in making the change to IFRS.

Corporate governance publications

Audit Committees – Good Practices for Meeting Market Expectations
Provides PwC views on good practice and summarises audit committee requirements in over 40 countries.

World Watch magazine
Global magazine with news and opinion articles on the latest developments and trends in governance, financial reporting, broader reporting and assurance.

Building the European Capital Market – A review of developments – January 2007
This fourth edition includes the key EU developments on IFRS, the Prospectus and Transparency Directives, and corporate governance. It also summarises the Commission's single market priorities for the next five years.

To order copies of any of these publications, contact your local PricewaterhouseCoopers office or visit www.cch.co.uk/ifrsbooks

IFRS tools

Comperio
Your path to knowledge
Online library of financial reporting and assurance literature. Provides the full text of IASB literature as well as ISAs, International Auditing Practice Statements and IPSAS. Also contains PwC's IFRS and corporate governance publications, and Applying IFRS. For more information, visit www.pwc.com/comperio

Get set for IFRS
Covers the potential changes of the proposed IASB regulation and the commercial impact expected.

P2P IFRS – from principle to practice
Interactive IFRS training
PwC's interactive electronic learning tool to bring people up to speed on IFRS. Contains 20 hours of learning in 37 interactive modules. Up to date as of October 2006. For more information, visit www.pwc.com/ifrs

Reporting under the new regime
Findings from a survey of the financial statements of large insurance groups. The report is designed to help insurers compare their disclosure against their peers' and help users of financial statements to interpret and understand the methods and presentational options adopted.

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