Business combinations and earnings implications in insurance: Navigating the tricky waters

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ACQUISITION ALCHEMY FOR INSURERS

In insurance, as in most business sectors, mergers and acquisitions remain a key part of long-term strategy and success. Insurers may acquire other insurers for any number of reasons. Regulatory and compliance pressures encourage consolidation in order to benefit from economies of scale and greater diversification within capital requirements. Other common reasons may include external pressures for growth greater than organic potential, strategic access to expertise and distributions channels, or simply shutting out a competitor.

Not surprisingly, parties to the acquisition make it a priority to consider valuations, regulatory implications (prudential and competition authorities amongst others), and the costs of integration and potential cost savings. For first-time acquirers, the impact of the transaction on earnings is often assumed to be obvious and intuitive and therefore secondary to other more fundamental business issues. More seasoned campaigners, however, have learnt that the earnings implications, while ultimately logical and rational, are not necessarily what was first expected.

Critically, earnings growth is an elusive target and differences in accounting and regulatory treatment of the transaction usually complicate reporting. Solvency measures often weaken in the short term. To make this even more complicated, the rules, both accounting and regulatory, have undergone significant change over time. Your understanding of these rules from 10 or 15 years ago may no longer be relevant. What is more troubling is that many advisors don't deal with these transactions regularly enough to understand all the subtleties until they are picked up during the first financial statement preparation after the deal is done.

This paper examines some of these issues related to calculating earnings that are facing insurance companies today as they prepare for mergers and acquisitions. It also includes discussion of the impact of the most recent regulations, such as International Financial Reporting Standards (IFRS) 3 and International Accounting Standard (IAS) 38. Consideration of issues related to goodwill, intangible assets, and their complex interactions in terms of accounting classifications is also included in this paper.

VALUE OF BUSINESS ACQUIRED

The largest intangible for an insurance acquisition depends on the type of insurer acquired. For an established life insurer, the largest source of value is usually the profits expected to emerge from the existing book. This is primarily because the accounting measurement of policyholder liabilities is usually significantly more conservative than fair value. The difference in the fair value of liabilities and their accounting measurements is actually a special kind of intangible and is measured under IFRS 4 (Insurance Contracts) rather than IFRS 3 and IAS 38.

GOODWILL AND INTANGIBLE ASSETS: DEFINITELY NOT SYNONYMS

Many people, even accountants and financial directors, seem to use the terms 'goodwill' and 'intangible assets' almost interchangeably. While they are related, there are fundamental differences in how they arise, how they are measured, their impact on earnings, and their messaging to savvy analysts.

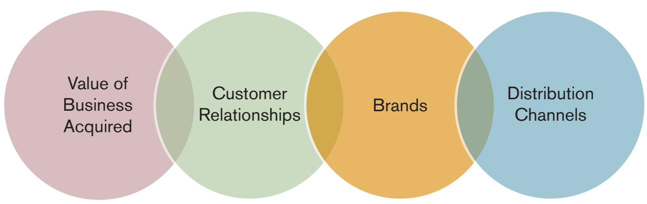
Goodwill is the ethereal difference between the value of an acquired business (technically a cash-generating unit, or CGU) and the value of recorded tangible and intangible assets. It is not amortised over time, although it is a widespread misconception that this is still the case. It should be regularly impairment-tested by comparing the value of the CGU with the carrying value of all underlying tangible and intangible assets and goodwill. If the CGU is worth less than the sum of these parts, then the goodwill must be impaired.

An intangible asset (in the context of business combinations or an acquisition) is a separately identifiable, measurable asset that can be placed on the balance sheet of the acquirer. It is normally amortised over its useful life and will thus contribute to future expenses. If the separately identifiable and measurable asset is worth less than the carrying value at any time, then the recorded value will be impaired.

This is often termed the 'value of business acquired,' or 'VOBA.' It may also be called the 'value of in-force,' or 'VIF,' because embedded value techniques are frequently used to calculate its value.

A short-term insurer or general insurer can also have a VOBA, but because the policies here will usually be fairly short term (a few years at most and sometimes just one to three months) the extent of the value is more limited.

FIGURE 1: COMMON TYPES OF INTANGIBLE ASSETS ACQUIRED IN A TRANSACTION



CUSTOMER RELATIONSHIPS

For many short-term insurers, although the 'contract boundary' is short (because the policy can be cancelled or repriced with only a month or a little more of notice), the expectation is that the policies will remain until at least the next annual renewal and many policies will renew beyond that for several years.

The source of value here can be termed different things, but a common name is 'customer relationships.' The insurer is expected to make profits from these customers not because of a contractual arrangement but because of a customer relationship that has been developed in the past.

Life insurers will also have 'customer relationship' intangibles when it comes to their group risk books, employee benefit administration arrangements, and asset management businesses.

As with other intangibles, the valuation here should not be a fuzzy gut-feel estimate, but rather a carefully modelled projection of expected future profits arising from the current book of customers, with appropriate assumptions for cancellation and renewal rates. The underlying assumptions will remain somewhat subjective and uncertain, as with any valuation, but the methodology and approach are robust and the result is not an unsubstantiated guess.

BRAND AND DISTRIBUTION CHANNELS

The target company may have a valuable brand or distribution contract that is expected to give rise to sales of future new business at higher-margin or lower-distribution cost or with less investment than the acquirer could achieve on its own. Depending on the nature of the business, this could be allocated entirely to brand or entirely to distribution channel, to somewhere in between, or to a differently named intangible.

A common question is for how many years to forecast value from this type of intangible. At first glance, this might seem like something that could generate value indefinitely. However, even the strongest brand and most loyal intermediaries will fade over time without reinvestment and reinvigoration.

While it will depend on the specific company involved, usually fewer than 10 years of future new sales are considered. In a South African context, three to five years of future sales is more common.

Of course, it's also common that the acquiring company doesn't intend to use the target's brand at all. Several life insurance transactions in South Africa have been priced close to embedded value, with implicitly no value placed on brand or distribution channel at all.

MEASURING WHAT YOU'VE BOUGHT

Most companies are worth more than their accounting book values. Similarly, many companies will control sources of value that for particular accounting reasons are not recorded as assets on their balance sheets.

Because the existing owners will want to be compensated for all these sources of value, whether they are recorded on the balance sheet or not, most acquisitions are concluded at a price above book value.

TOP MISTAKES AND MISUNDERSTANDINGS

- Acquisitions usually aren't very earnings-enhancing, unless more is done with the business than was priced for in the transaction and valuation of the intangible assets.
- For value of business acquired (VOBA) assets, even though they are usually calculated net of tax, the intangible asset recorded must be grossed up for tax and a separate deferred tax liability held.
- Goodwill is not the same as an intangible asset.
- VOBA for long-term individual life policies should be treated differently from the value of customer relationships under life group risk, short-term insurance, or investment management services policies.
- Value can only be placed on something that was acquired. For example, if a block of business is acquired from a partner where the brand and distribution was always owned by the acquirer, then it's highly unlikely that any value could be placed on future new business or a brand or distribution channel that would give rise to future new business.
- Deferred acquisition costs (DAC) assets from commission paid by the target in the past must be removed and replaced with an identifiable intangible asset.
- Transaction costs, other than costs of issuing debt or equity to finance the deal, must be expensed.
- Acquired policies must be tracked separately from existing or new policies, especially when migrating data between systems. This information is required to track the value of intangible assets for impairment testing.

A naïve (and incorrect) accounting treatment would be to record the acquisition at its book value, record the larger decrease in cash (assuming the purchase price is paid in cash), and show a potentially significant loss on completing the transaction. While the balance sheet might be argued to be sensible and consistent, most would agree that showing a significant loss on a very sensible transaction isn't particularly useful. A secondary consideration is that this accounting treatment would strongly discourage mergers and acquisitions. Assuming the transactions were sensible, this would lead to suboptimal economic outcomes.

IFRS 3 addresses this issue in a superficially neat way, but one with messy aftereffects.

IFRS 3 requires the measurement of three items of value:

1. Items from the target firm's balance sheet will be consolidated directly onto the acquirer's balance sheet.

2. Any identifiable assets (not already included on the target firm's balance sheet) can be raised as intangible assets on the balance sheet of the acquirer.

3. Any additional amounts transferred as part of the acquisition can be recognised as goodwill. The value of goodwill should be calculated as follows (IFRS 3, paragraph 32):

   Goodwill = Consideration transferred + the amount of any non-controlling interests + fair value of existing equity holdings − net asset value of target firm − any intangible assets raised as part of this transaction.

   The acquirer has the choice of whether to measure any non-controlling interests at fair value or at net asset value. This accounting policy choice should be made per transaction and can vary between transactions.

The result is that the IFRS equity of the purchased entity after acquisition should be equal to the purchase price.

Any intangible assets are measured on a gross of tax basis and a corresponding deferred tax liability should be raised. This is another common area of incorrect treatment, which usually has no earnings impact but might affect the gearing ratios of the business. This can be problematic if not considered for already highly levered businesses or where debt is used to finance the transaction, and if debt covenants or regulatory approval is dependent upon maintaining limited gearing ratios.

Goodwill is created on a net of tax basis only.

If the acquirer were not allowed to raise intangible assets and goodwill, the acquirer would have had to recognise a loss on its income statement whenever it acquired a business for a consideration greater than net asset value (as the consideration transferred, i.e., reduction in cash, exceeds the net asset value received).

INTANGIBLE ASSETS AND GOODWILL DO NOT COUNT FOR SOLVENCY

Intangible assets (other than deferred acquisition cost assets related to commission and other acquisition costs related to selling insurance policies) are eliminated on the regulatory balance sheet. It is therefore unavoidable for an insurer to recognise a loss on the regulatory balance sheet when acquiring another insurer at a price greater than net asset value (NAV).

This effect will be reduced with the introduction of Solvency Assessment and Management (SAM). Broadly speaking, SAM will recognise some of the future profits paid for in the purchase price as lower liabilities. That is, lower premium provisions for short-term/general insurance business and lower technical provisions for life insurance through greater capitalisation of future profits. However, this doesn't affect profits expected to be earned from beyond the policy contract boundary.

SAM also allows insurers to recognise 20% of *very specific* intangible assets as Tier 3 Capital. The applicable intangible assets here are only those which can be fair-valued and separately traded. In practice, we would expect virtually no intangible assets to meet these requirements for insurers if the rules are correctly applied. This is also an area where many insurers are currently not applying the rules correctly during the Comprehensive Parallel Run.

IFRS 3 AND 'CONTROL'

International Financial Reporting Standards (IFRS) 3, Business Combinations, is the accounting standard that applies whenever an entity gains *control* of another *business*. Two key requirements need to be met in order for this standard to apply:

- **Control** needs to be obtained over the target firm during the transaction. Note that the definition of 'control' from an accounting perspective is not necessarily synonymous with obtaining a majority shareholding.

- A **business** needs to be acquired. Paragraph B7 of IFRS 3 defines a business as: '…inputs and processes applied to those inputs that have the ability to create outputs.'

If these requirements are not met, the acquisition will likely be accounted for as an equity investment, in which case other accounting standards apply.

Example

The following numerical example illustrates this calculation:

- Company A acquires a 100% interest in Company B for a consideration of ZAR 1,000.

- The net asset value of Company B is ZAR 500.

- Company B has an existing book of insurance business, which Company A considers to be worth ZAR 200 (VIF net of tax and assuming zero cost of capital).

- *There are no other identifiable and measurable intangible assets.*

IFRS 3 requires Company A to raise an intangible asset relating to the VIF of ZAR 200, which was purchased. The intangible, however, should be raised gross of tax and a corresponding deferred tax liability should be created.

The table in Figure 2 shows this numerical example.

FIGURE 2

CALCULATION OF GOODWILL	VALUE IN ZAR
Consideration transferred	1,000
- NAV of target firm	500
- Intangible created	278
+ Deferred tax liability on intangible	78
Goodwill	**300**

ACCOUNTING CLASSIFICATION AND SUBSEQUENT MEASUREMENT

Goodwill

Under IFRS, goodwill is not amortised over time. However, goodwill must be tested for impairment at least annually, per IAS 36 (Impairment of Assets). The impairment test involves checking that the fair value of the business acquired at the subsequent reporting period is greater than the sum of the net asset value of the business acquired plus the value of any associated intangibles (less deferred tax liabilities) plus the value of goodwill.

In other words:

Goodwill ≤ Fair value of business acquired – Net asset value of business acquired – Associated intangibles net of deferred tax liabilities

Therefore, in order to perform the impairment test, the fair value of the business acquired needs to be determined. This can be an onerous process and as a result the impairment test is not typically performed more frequently than annually.

It is important to note that an impairment of goodwill cannot be reversed in subsequent reporting periods. This is different from how intangible assets are treated, as will be described in the sections to follow.

Accounting classification

The subsequent measurement of the value of intangible assets depends on the accounting classification of the underlying contracts.

In general, IAS 38 describes the subsequent measurement of the value of intangible assets and IAS 36 describes how the value of intangible assets should be tested for impairment. However, intangible assets arising from insurance contracts within the scope of IFRS 4, Insurance Contracts, are excluded from the scope of IAS 38 and IAS 36. The subsequent measurement of the value of such intangibles is described in IFRS 4.

The acquirer therefore needs to separately measure the value of any intangible assets on:

- Value arising from insurance contracts, or investment contracts with discretionary participation features (DPF), within the contract boundary
- All other sources of value (including renewals on insurance contracts and expected future fees on investment management service contracts)

The subsequent measurement of the value of intangible assets under the first point above will be governed by IFRS 4, while the subsequent measurement of the value of intangible assets under the second point above will be governed by IAS 36 and IAS 38.

The sections below discuss the measurement approach separately for these groups of contracts.

Insurance contracts and investment contracts with DPF

IFRS 4 does not provide clarity on how the value of intangible assets should subsequently be measured, other than paragraph 31, which states: '…The subsequent measurement of this asset shall be consistent with the measurement of the related insurance liability.'

This sentence is open to interpretation. Typically insurers amortise the value of the intangible in line with the amortisation of the VIF.

IFRS 4 does not require an impairment test to be performed, but it does require a liability adequacy test. The liability adequacy test requires the insurer to assess at the end of each reporting period whether its total insurance liabilities (less related deferred acquisition costs and intangible assets) are adequate, using current estimates of future cash flows. If the liabilities are not adequate, the entire deficiency should be recognised in profit or loss.

The liability adequacy test should be performed on the insurer's entire book of insurance business as a whole (as opposed to on each individual intangible asset). The liability adequacy test is therefore a less onerous test, especially for insurers with retrospective unearned premium provisions, conservative incurred but not reported (IBNR) reserves, zeroisation of negative discounted cash flow reserves (adding a discretionary margin to increase a negative reserve to zero), or significant other discretionary margins.

Nevertheless, most insurers choose to apply a stricter standard and test the recoverability of each individual intangible asset on insurance business (i.e., an approach that is consistent with the IAS 36 impairment test). Such an approach appears to be consistent with the principles currently proposed for IFRS 4 Phase II, which requires the contractual service margin to be calculated separately for each cohort of business.

Other sources of value outside the insurance contract boundary

IAS 38 requires intangible assets to be amortised over their useful lifetime. Paragraph 97 states that the amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed. If that pattern cannot be determined reliably, the straight-line method shall be used. Typically insurers amortise the intangible asset in line with the expected run-off of future profits, where this is related to fees or profits from insurance policies or straight-line for other intangible assets or where simplicity is preferred.

IAS 36 requires intangible assets to be tested for impairment. This is typically done by comparing the gross of tax VIF at the reporting date with the value of the intangible asset. Should the VIF be less than the value of the intangible, the intangible asset will be impaired (and the deferred tax liability adjusted accordingly).

The standard further states that, in the event that an impairment is necessary, goodwill should be impaired first (before any other intangible assets). It is therefore not possible to impair the value of an intangible asset on a business acquired while there is goodwill on the balance sheet relating to the acquisition of that business.

Impairment losses on intangible assets (other than goodwill) can be reversed in subsequent reporting periods, should the circumstances leading to the impairment loss no longer exist or have been reduced. Impairment losses on goodwill, however, cannot be reversed.

Revaluation of insurance contracts

It was mentioned above that IFRS 4 does not provide clarity on how the value of intangible assets should subsequently be measured, other than paragraph 31, which states: '…The subsequent measurement of this asset shall be consistent with the measurement of the related insurance liability.'

This paragraph does not prohibit the insurer from revaluing its intangible assets as a result of changes in assumptions or estimates (in fact, some practitioners might argue that intangible assets should be revalued at each reporting period, as this is 'consistent with the measurement of the related insurance liability'). This will be discussed in further detail in the section to follow.

CAN'T BUY ME EARNINGS (MOSTLY)

One of the most disappointing realisations for many new to the world of business combination accounting is that 'you can't buy earnings.' Generally speaking, even sound deals have limited impact on earnings unless significant value is unleashed by management after the deal. The hardest work starts once the deal is complete.

If actual experience turns out to be exactly equal to assumptions used to value the intangible asset, the impact on earnings (of the acquisition) will be exactly equal to the unwind of the discount rate used in the valuation of the intangible asset less transaction costs.

Consider an example of a book of insurance business expected to produce profit equal to ZAR 100 at the end of each of the next five years. The discount rate is 10% p.a. and tax and transaction costs are ignored. This impact on earnings is shown in the table in Figure 3.

FIGURE 3: EARNINGS ILLUSTRATION: ACTUAL EQUAL TO EXPECTED

YEAR	PROFIT	INTANGIBLE	EARNINGS
0	0.00	379.08	
1	100.00	316.99	37.91
2	100.00	248.69	31.70
3	100.00	173.55	24.87
4	100.00	90.91	17.36
5	100.00	0.00	9.09
Total	500.00		120.93

Earnings in the table in Figure 3 were calculated as profit minus the amortisation of the intangible asset. It can be seen that earnings is exactly equal to the unwind of the discount rate (i.e., 10% of the opening value of the intangible asset). A deal that gave rise to ZAR 500 of future cash flows and cost ZAR 379.08 in up-front cash only delivers ZAR 120.93 of earnings over the lifetime of the deal.

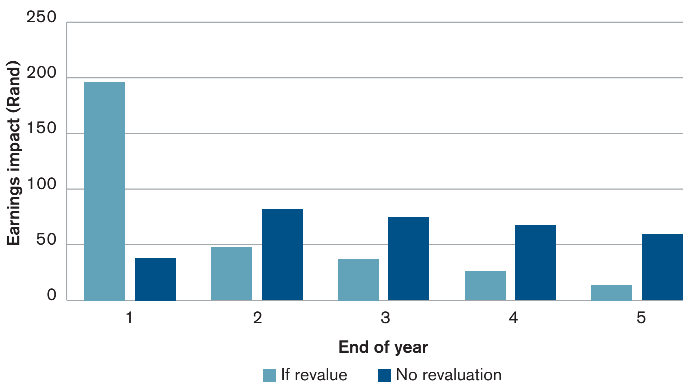
The earnings impact might be less than the investment return that could have been earned on the purchase price had the deal never been done.

If there is a change in estimates, the insurer has some discretion in whether or not to revalue the intangible asset, depending on other accounting choices.

Consider the same example as shown in Figure 3, except that at the end of year 1 there is a change in assumptions, which results in expected profits being ZAR 150 per year from year 2 onwards, instead of ZAR 100 per year.

The impact on earnings of the two options is shown in the graph in Figure 4.

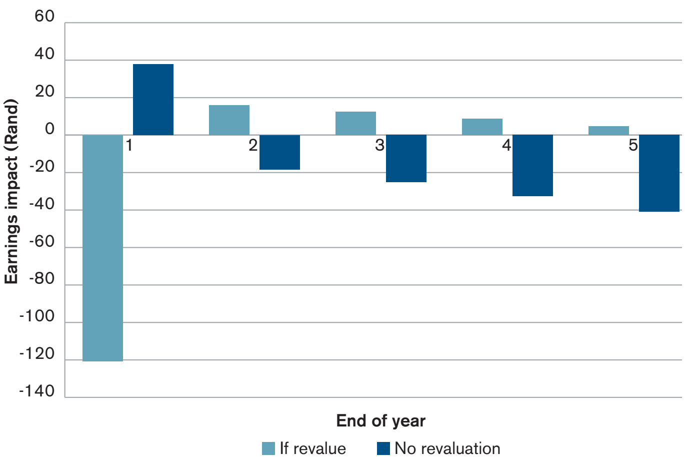
FIGURE 4: EARNINGS IMPACT, WITH AND WITHOUT REVALUATION



Revaluing the asset results in an increase in earnings in the first year, with lower earnings emerging over time, while no revaluation results in higher earnings over time.

The graph in Figure 5 shows the same scenario, except for a reduction in profits from year 2 onwards (in this example, profits were reduced to ZAR 50 per year, from ZAR 100 per year).

FIGURE 5: EARNINGS IMPACT, WITH REDUCED PROFITS



It should be noted that the insurer is not necessarily forced to adopt this approach, because the liability adequacy test needs to only be applied on the book of insurance business as a whole and the revaluation of the intangible depends on several factors.

The decision as to whether or not to revalue intangible assets does not impact the total amount of profit to emerge over time. It only impacts the timing of the emergence of profits.

Differential treatment of intangibles and goodwill in headline earnings requires some caution

The amortisation and impairment of intangible assets (and changes to the value of the associated deferred tax liabilities) is recognised in 'headline earnings.' However, the impairment of goodwill is not recognised in 'headline earnings,' which is a term specific to the JSE Securities Exchange, with guidance on what is included provided by the South African Institute of Chartered Accountants (SAICA).

If 'headline earnings' is one of the main metrics targeted by the acquirer, there is an incentive for the acquirer to declare a lower value of intangible assets (and therefore a higher value of goodwill). This is contrary to the more usual view that large goodwill balances are viewed with some scepticism or concerns that companies have been acquired at expensive prices.

GETTING TO SEAMLESS TRANSITIONS

This paper has outlined some important considerations to discuss with your advisors early on when contemplating purchase or sale of a company. Ultimately, valuation and business strategy should be primary considerations, but solvency and financial statement impacts can derail otherwise sound transactions. It's critically important to consider a wide range of issues for any such transaction, including some of those discussed in this paper: current accounting and regulatory requirements, goodwill, intangible assets, and perhaps most importantly an accurate and well-founded estimate of earnings.

There are many other key considerations as well, which are not covered in this note and could well apply to the specifics of a transaction you and your business are contemplating. Seek out robust advice from a trusted advisor—and choose one with experience with transactions in the insurance industry, the business sense to understand the questions that should be asked, and the objectivity to provide the hard answers whether you want to hear them or not.

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