

broking**business**

After you've gone

Succession planning

FSA principles

How they affect ARROW visits

European tax changes

The broker's perspective



Welcome



We hope the New Year has been a happy and prosperous one for you so far. It is, of course, traditionally a time to take a clean sheet of paper and make resolutions. You may have joined the local gym or vowed to drink less this year, but why not also use the momentum to think about succession planning for your business?

Succession planning may feel as remote as retirement does to, say, someone under 40. But it is an inevitability for all companies and, like everything else, an early, planned approach is the best way. In fact, a succession strategy should be based on a plan period of at least three years. For more guidance, turn to my feature on the centre pages where I consider how to achieve the important balance between built value, continuity of

service for clients, and securing the future of the business for remaining colleagues.

Since the changes in regulations for premium taxes that followed the opening up of the European insurance market, you may be experiencing confusion over the broker's role in relation to your clients' IPT responsibilities. You certainly wouldn't be alone. On page 6 we offer advice on getting to grips with identifying liabilities and helping insurers account for their taxes worldwide.

For more advice on these and other broking issues, contact one of our team or email broking@clblf.com

David Roberts, Partner – Financial Services

In brief



John Needham is a partner in the firm's financial services division, specialising in insurance. He is also a member of the broking team, which caters for the needs of insurance brokers and other intermediaries.

Debt finance comes to the crunch

Brokers looking to raise debt finance may find that the free flow of funding which has been available over the past few years is starting to dry up. The fallout effects of the credit crunch may start to bite, with lenders tightening their term sheets and building more prudence into their lending.

CGT confusion

There has been much speculation about the new CGT regime proposed in the Government's recent pre-budget announcement: as it stands it could have the effect of accelerating the number of brokers being disposed of. On 3 December, following pressure from lobby groups, the Government announced that the new CGT regime proposal would be reviewed. This is obviously a nightmare for planning purposes. But if the proposed changes are overturned, a great many brokers selling their businesses will benefit. Check www.gnn.gov.uk, or contact us to get an update on the latest position.

Commission disclosure

The FSA has stated that it will continue to investigate and apply pressure on the insurance industry to improve the disclosure of commissions, conflicts and commercial arrangements. This comes despite an independent review carried

out for the FSA which concludes that on a cost-benefit basis the case for mandatory commission disclosure is not robust.

See <http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/126.shtml> for further details.

VAT: exempt or not exempt?

A recent decision made in the case of InsuranceWide.com has reinforced HM Revenue & Customs' view of the scope of the insurance intermediaries' exemption from VAT. InsuranceWide provided an online introductory service but specifically disclaimed itself on its website from being an agent. It took no part in contract negotiation and it had no power to bind insurance companies to a contract. The tribunal found this introductory part of InsuranceWide's services to be subject to VAT.

Interestingly, in 2002 InsuranceWide introduced the InsuranceWide Wizard, which helped customers' policy selection process and recorded information required by insurers. The tribunal found that this aspect of the service would qualify for exemption if it were provided by an insurance agent or broker. So, by removing itself from being an agent, InsuranceWide effectively excluded itself from the exemption.

ARROW visits in a principles-based world

The FSA's move towards more principles-based regulation (PBR) has resulted in a change of emphasis during its visits. Rules are 'out' and what the FSA Principles mean to firms is 'in'. John Gregson reports.

Top three priorities for 2008? Probably Principle 3 'Governance'; Condition 2 'Threshold Conditions'; and Principle 6, 'Treating Customers Fairly', since these three contribute significantly to the achievement of two of the FSA's Statutory Objectives – protecting the consumer and maintaining market confidence.

Governance

Principle 3 requires firms to take reasonable care to organise their affairs responsibly and effectively, with adequate risk management systems. In other words, there should be good governance in the firm.

Threshold conditions

For a firm to remain authorised, threshold conditions must continue to be met. Condition 4 - adequacy of resources – is at the heart of these conditions and increasingly firms must demonstrate to the FSA that they are in compliance.

By and large, firms are familiar with the financial resource requirements as prescribed by the FSA. Essentially, a firm's financial resources must exceed those requirements and from January 2008 those resources can no longer include 'goodwill'.

Firms may be less familiar with non-financial requirements which include 'human', 'internal' and 'external' resources. Firms should be able to demonstrate, for example, that:

- they are managing their 'people risk'¹ i.e. that there are sufficient people in the right place at the right time and with the required competencies

- internal audit, risk and compliance functions are sufficiently resourced
- sufficient controls are in place to manage the risks associated with Appointed Representatives and outsourcing partners providing 'material services'.

Treating customers fairly

Much has been written about 'Treating Customers Fairly' (TCF) – the FSA's Principle 6 – and two deadlines are looming in 2008. By the end of March, firms should have appropriate management information or other measures in place to enable them to test whether they are treating their customers fairly. By the end of December 2008 they should be able to demonstrate that they are. Expect most ARROW visits of whatever purpose to include this subject on the agenda and be ready to deal with it. If you are not well on the way to meeting these deadlines then you can expect a lot of attention.



With 30 years' experience in the general insurance industry, **John Gregson** of Neo Consultancy currently advises firms on their FSA compliance. He is a Special Adviser to the FSA.

Conclusion

ARROW visits have changed. You must be able to demonstrate your understanding of the Principles and how your firm adheres to them. You must make and retain evidence of your control framework and be able to describe the culture that drives your firm to support your assertions. The FSA has beefed up its Enforcement team and warned that it will get tough with firms that aren't up to scratch.

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CEO checklist

- I am able to explain what the Principles for Business mean in practice in my firm
- The Board has set a strategy for the firm and this has been communicated to all employees
- The Board reviews its effectiveness, and that of its individual members, at appropriate intervals
- I have apportioned my responsibilities to members of my senior management team and am confident that the required systems and controls are in place and are functioning as they should
- The management information I receive enables me to identify risks to my business in sufficient time to manage them
- The Threshold Conditions are understood by the Board and adherence to them is reviewed by the Board at appropriate intervals
- I and my senior management team promote a culture that supports our policies to treat clients fairly
- I have put measures in place that enable me to test whether my firm is treating its clients fairly
- Members of the Board and my senior management team are aware of the types of issues that need to be reported to the FSA if they occur
- I can produce evidence, if called upon to do so, that demonstrates my firm's adherence to the Principles for Business

¹ Principles-Based regulation – People Risk www.advantagebroker.co.uk



After you've gone:

Insurance broking is a relationship-oriented business. Never more so than when dealing with succession. David Roberts provides some pointers.



David Roberts is head of the firm's financial services division and of the broking team. He specialises in advising the London insurance market and is a regular commentator on market activity in the insurance press.

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Many firms are founded and run by individuals or small teams and, in most cases, those individuals are key to the success of the business. More often than not they stay with the business until their career winds down and they want to exit.

At that point the key objectives for the exiting individuals include maximising the built value they can extract from their exit, securing continuity of service for clients, and securing the future of the business for the benefit of continuing colleagues who may have contributed greatly to its built value. Achieving a balance of these requires a clear strategy for succession.

Securing the built value

What the exiting owners can get out of any buyer of the business, whether internal or external, will be based on what those incoming owners think the business is worth to them, both now and in the future. Broking is a people business: for an external buyer the main risk in any purchase is that key personnel will leave and a substantial element of the business will leave with them. That risk will normally lower the buyer's valuation, although there is of course scope to mitigate the risk through lock-ins, earn-outs and other mechanisms enabling the valuation risk to crystallise over time rather than up front. However it is framed, the terms of any exit

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What are the key steps?

- Understand your goals: consider family succession, how much money you want to make out of exit, how much you want to reward people continuing in the business, and how involved you want to remain.
- Seek professional advice in framing your succession strategy and plan.
- Continue to plan for the next phase of the business beyond your exit, and continue to adopt business improvement strategies to increase value and to improve the quality of the business' earnings.
- Identify and groom successors: consult the new generation of managers and build their aspirations into the succession plan.
- Build a relationship with funders who will support your proposed plan.

succession planning

will need to incentivise new owners to pay the built value of the business.

The main advantage of coupling a transfer of ownership with succession in leadership is that this is likely to best preserve the value of the business, as the new owners are also the individuals best placed to secure that business value. In addition, if such an outcome is clearly envisaged, planned and communicated across the firm, that is likely to incentivise rising stars to stay in the business as they will see a clear and definite opportunity to secure an ownership interest. It will, of course, be necessary for an exiting individual to leave enough value in the business to provide a reasonable risk/reward equation for the succeeding owner/managers.

Securing continuity

Broking is based on trust supported by a record of delivery of high-quality service. Neither can be easily transferred if it is identified only with key individuals, and it is therefore essential to plan over the long term to preserve what is effectively the business brand when key senior individuals exit. To be really effective this will involve some transfer of the value in the business to a wider group of personnel, and for this reason many brokers have been reluctant to go down this path to any significant degree. What is necessary is a well thought out succession strategy and a planned approach, enabling the necessary preparation to take place within a controlled framework.

What is the timeframe? Valuable relationships are not short-term,

and remaking them in a new image will probably take years not months. A succession strategy should therefore be based on a plan period of at least three years.

Funding

For a succession transfer to continuing management, the funding strategy must support the payment of built value to the exiting individuals. The succeeding management may well have young families and considerable long-term outgoings. It may well be difficult for them to find funding without bricks and mortar security. However, and especially where there is a solid framework for that succession and the business fundamentals are sound, there are lenders who will fund succession transactions on the basis of the future business cash flows.

Insurers: **crossing** **the border**

The opening of the European insurance market has brought both new competitive challenges for insurers and brokers and the need to deal with increasingly convoluted fiscal requirements at home, across Europe and worldwide. Bob Jones reports.

The European Economic Area (EEA) insurance market was rationalised with the introduction of the Third Insurance Directive in 1995, although it took a European Court of Justice decision in 2002 for the premium tax impact to bite. The liberalisation of this market not only encouraged insurance companies to become more active across borders; it also boosted the number of multi-regional contracts.

The imposition of levies on insurance contracts in Europe is

multifaceted. In addition to taxes on insurance premiums, there are often other tax-like fees due. In some countries so-called stamp fees are charged for issuing insurance certificates.

There is a great variance in regulations, tax rates, types of taxes, filing and payment dates, and documentary requirements within the EEA, not to mention language difficulties. There are also stringent penalties in some countries for failing to comply.

In addition, many European countries require the appointment of a fiscal representative, with joint and several liability, to be responsible for reporting and paying premium taxes on behalf of the insurer. The compliance costs often negate the increased competition and efficiency of trans-regional contracts, which the rationalisation of the insurance market was intended to foster.

Simplification of premium taxes through a European-wide tax harmonisation is currently not in sight.

The broker's perspective

Brokers play a pivotal role in the collection and distribution of premium taxes to insurers. To a certain extent, insurers are dependent on brokers to help them comply with their insurance premium tax (IPT) responsibilities. The situation becomes increasingly difficult in the case of multinational, multi-insurer policies where brokers receive premium and IPT and other taxes from insureds worldwide - for reallocation to insurers. The mechanism and responsibility for accounting for the taxes may be unclear to both the broker and the insurer. In some cases, the broker

Who pays the tax authority?

The insurance tax is due upon payment of the insurance premium and is normally collected from the insured, with the insurer having the obligation to report to, and pay, the tax authorities. However, in some countries, such as Sweden and a number of non-EEA countries, the insured or the broker has the responsibility of paying direct to the tax authority.

In the EEA, insurance taxes are settled depending on the location of the risk, and therefore non-European insurers, e.g. insurers established in Jersey, Guernsey or Bermuda, also have a legal obligation to register and account for premium taxes collected.



may be responsible for accounting for the taxes on behalf of the insured. In others it might be more practical for the broker to volunteer to act as tax representative for the pool of insurers to streamline and minimise the cost of compliance.

Brokers need to be aware of the potential effect on insurers of the Mutual Assistance Directive to IPT and the extension of mutual assistance beyond the EU under the International Tax Enforcement Arrangements. The introduction of mutual assistance and exchange of information between countries may well expose insurers to increased monitoring of non-reported taxes across the globe. Brokers are ideally placed to identify liabilities and help insurers account for taxes worldwide.

There is also the question of unallocated premiums and taxes. Brokers may retain unallocated premiums and taxes for considerable periods of time, sometimes years, before returning them to the insurer. This puts the insurer at risk of non-compliance in respect of tax accounting, potentially with implications for FSA compliance. A delay in returning premium and tax to the insurer can also raise compliance issues in the country in which the tax is due. For example, tax collected in Germany in 2006 will be at a rate of 16%. If it is not returned to the insurer until 2007, when the rate is 19%, the

insurer will have difficulty in returning the tax and could be penalised for late payment.

As the world of premium taxes changes, brokers need to change with it to ensure that they continue to provide a service to insurers which is both comprehensive and competitive.

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Indirect taxes partner **Bob Jones** has more than 30 years' experience of advising insurers and other companies on the complexities of the indirect tax system. He works closely with our international associate Polaris International to provide insurers with cross-border tax solutions.



Accounting policy review

Over the next few issues of *Broking Business*, Jessica Wills will be reviewing some of the key accounting policies adopted by firms and commenting on significant trends and issues.

The regulatory aspects of goodwill are a current hot topic for firms. In this article, however, we consider in outline the financial aspects of accounting policies relating to goodwill and other intangible assets.

Our review is based on information contained in the latest available financial statements for 45 of the Top 50 firms (as compiled by IMAS corporate advisers).

Accounting treatment – the background

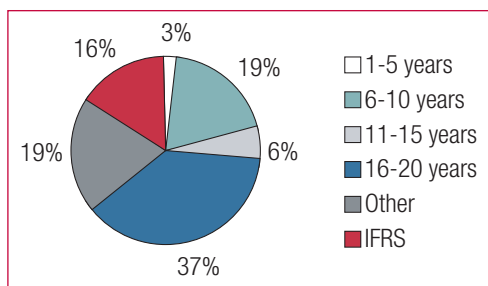
Under UK GAAP, FRS No.10 states that goodwill and other intangible assets should be recognised as an asset on the balance sheet and amortised on a systematic basis over their useful economic life. There is a rebuttable assumption that 'useful economic life' is limited to 20 years or less. Most firms included in this review operate under UK GAAP.

Under IFRS, IFRS No.3 and IAS No.38 state that goodwill and other intangible assets should be recognised as an asset on the balance sheet and reviewed annually for impairment (or more frequently if events or changes in circumstances indicate that it might be impaired). Only seven of the firms reviewed adopt IFRS.

Balance sheet analysis

	UK GAAP	IFRS	Total
Number of firms with intangible assets	27	5	32
Goodwill	£1,103m	£329m	£1,432m
Other intangible assets	£4m	£53m	£57m
Total intangible assets	£1,107m	£382m	£1,489m
Net assets	£1,343m	£491m	£1,834m
Total intangible assets as % net assets	82%	78%	81%

Amortisation period used in Top 50 brokers



Conclusion

Our review demonstrates that in the Top 50 firms there are a significant amount of intangible assets (predominantly goodwill).

Our balance sheet analysis of the intangible asset to net asset ratio indicates that the market is highly sensitive to accounting policies adopted in respect of intangible asset recognition, amortisation

and/or impairment. This is not surprising when 81% of the net assets of the 45 firms reviewed is goodwill. The market trend of consolidation, the increase in acquisition multiples and the fact that much consolidation activity is funded by debt are key factors in driving this ratio of intangible assets to net assets.

Our sensitivity analysis shows:

- Six firms have net liabilities if intangible assets are removed from the balance sheet
- One firm would turn from profit to loss if the amortisation period was reduced from 20 to 10 years
- Three firms would halve their profits if the amortisation period was reduced from 20 to 10 years

This analysis raises the question of whether firms would benefit from a change to IFRS – where intangible assets are subject to annual impairment review rather than an annual amortisation – with such a change potentially improving future profits for some firms by a significant margin.

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Our dedicated financial services division offers extensive experience and expertise. Our particular strength is in the London insurance market, where we have worked for over 100 years. In this time, we have built up a comprehensive business and technical understanding of the workings of the industry, backed by detailed and practical knowledge of the unique challenges and issues faced by the insurance market.

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