

LITTLEJOHN

brokingbusiness

The newsletter for
insurance brokers

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Putting FSA Principles into Practice

Proving your firm's integrity

Broker Internal Audit

Empower your Internal Audit team

Accounting Policy Review

Revenue recognition and disclosure





Welcome to Broking Business

Change happens fast and frequently in the broking business. Currently the pressure is on for brokers to think more and more about how they do business and to find new ways of managing risk and conflict. As the industry as a whole is forced more in line with larger financial services organisations, smaller brokers with fewer resources need to find new ways to manage the changes.

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Change has been a theme at Littlejohn too recently. We outgrew our old building, so in May we moved into a larger office in Canary Wharf. Meanwhile, our name outgrew us; getting longer and longer with the organic growth of the firm. We've changed it to Littlejohn; a more accurate reflection of who we are today.

This edition of Broking Business has three articles: principles-based regulation, risk-based thinking, and commission disclosure. John Gregson gives us his insight on

how brokers can show adherence to Principle 1, John Needham discusses risk control through Internal Audit, and Jessica Wills reveals the findings of a review of brokers' commission/fees disclosure. We hope the articles give you some useful tips for addressing the regulatory shift.

We look forward to welcoming you to our new offices soon.



In Brief

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

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CGT Entrepreneurs' Relief – clarifying the rule change

The business disposal concession introduced as a softener for the new CGT rule is better news than many brokers initially thought judging from the post budget flurry of tax and deal-structuring enquiries we received. It applies to individuals rather than firms meaning that each shareholder can claim £1,000,000 CGT relief. For example, if your business has five shareholders, you're entitled to a total £5,000,000 tax relief. Entrepreneurs' Relief can be claimed any number of times up to a lifetime limit of £1 million. Shareholders must be employees of the business to qualify. Will the new rule herald the reappearance of spouses in the workplace?

RMAR - how strong are your assets?

It's worth taking a closer look at your balance sheet to check that your assets stand up to FSA inspection. In recent communications the FSA has indicated an intention to consider balance sheet strength rather than pure numerical position. Any firms the FSA feels may be paying lip service to (TC4) may face investigation.

Insurance Mediation Directive: to review or not to review?

Confusion reigned over EU plans to review the Insurance Mediation Directive (IMD) at this year's FSA Annual Insurance Sector Conference. Charles McGreevy announced its full implementation in all member states (a good three years after the UK was forced to comply), while Hector Sants welcomed the Commission's commitment to developing a better regulatory environment by undertaking a new review of the IMD. Are we seeing signs of a two speed single market?

Hot topics at BIBA conference

Two subjects emerged as the hot topics around the water-cooler at the recent BIBA conference. The inevitable mandatory commission disclosure issue seems an unstoppable beast. The second subject was premium rates. As one broker commented: "if you hear people saying that rates are increasing they are definitely not telling the truth." M&A was also on the minds of many delegates, with several quizzing us on whether we've seen a slow down. Our view is no: firms seem as keen as ever to do deals. Next year's BIBA conference will take place in Manchester on 13-15 May.



Broker Internal Audit

Running a strategic internal audit programme gives you a valuable management tool for controlling major risks to your business. How do you find the time and source the skills to make it effective while keeping the costs down?

Brokers have been slow to embrace Internal Audit (IA) despite pressure from the Regulator. With the recent move to a risk based approach this situation is changing fast, particularly amongst medium sized brokers. Firms are prioritising FSA hot topics and client related areas, such as the activities of the broking teams.

The next set of more diverse areas they are tackling move beyond client facing areas to the back office. Depending on your particular set-up and areas of risk, you might consider applying IA to:

- correct function of key pieces of software
- integration of new business units
- IT infrastructure and security
- management information
- corporate governance
- human resources.

Some firms currently consider these no-go areas. Many lack the time or the skill levels in-house to carry out IA to a standard that results in meaningful output. An increasing number of firms are seeing the value and cost-effectiveness of outsourcing some or all of these areas to organisations such as ourselves with audit skills and specialist knowledge of the sector.

The outcome of having a comprehensive suite of effective IA tools in the box is that you can use it more strategically. Ideally it provides you with answers to crucial questions across all functions of your business:

- How does this process work?
- Is it being implemented properly?
- Can I rely on consistency of implementation?
- Can we do this better?
- Are we using best practice?
- What do other firms do?

Armed with the answers to these questions, you are equipped to control the major risks likely to affect your business. Music to non executives', audit committees' and the FSA's ears.

An increasing number of firms are seeing the value and cost-effectiveness of outsourcing some or all of these areas to organisations such as ourselves that have the breadth of skills and specialist knowledge of the sector.



Putting the Principles Into Practice

The FSA's Principles for Business provide the 'operating framework' within which firms should act, expressing what is required by COND 2: 'A Firm must satisfy the FSA that it is 'fit and proper' '.

With 30 year's experience in the general insurance industry, **John Gregson** of Advantage Broker currently advises firms on their FSA compliance. He is a Special Advisor to the FSA.

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In the first of a series of articles, John Gregson, CEO of Advantage Broker, looks at the meaning behind the first of the FSA's Principles for Business and gives his view on what firms can do to demonstrate adherence.

Principle 1: A Firm must conduct its business affairs with integrity

This is the over-arching Principle, the outcomes of which are arguably the FSA's four statutory objectives – maintaining confidence in the financial markets; protection of the consumer; education of the public; and prevention of financial crime.

'Conducting business affairs with integrity' means acting honestly at all times and in accordance with an internally consistent framework. For regulated firms, it is the set of Principles itself that provides the required framework. This means that breach of any of the other Principles might well lead to breach of Principle 1 depending on the nature and seriousness of the matter. And as we shall see later, the penalty for such a breach is the most severe available to the FSA.

Culture

A firm's starting point for demonstrating adherence to the 'integrity principle' is its culture, as this will drive employee behaviours including, importantly, those of senior management. Those behaviours in turn influence the firm's relationships with the FSA and other third party stakeholders such as markets, clients, suppliers/outsourcers and appointed representatives/agents. Firms should have appropriate agreements in place for each stakeholder group and be able to demonstrate that they keep to them. The collection of appropriate management information and being seen to act upon it is crucial.

Behaviours that demonstrate a lack of integrity include deliberately and/or knowingly:

- misleading clients, the FSA, auditors or markets
- not correcting a misunderstanding of a material issue
- preparing inaccurate records in connection with a controlled function
- misusing client assets or confidential information
- designing transactions to circumvent the regulatory system
- failing to disclose a conflict of interest to a client
- being unable to justify the suitability of a product sale.

It is worth noting that some of this behaviour amounts to criminal activity because it is fraudulent and would be prosecuted as such.

Senior management

The FSA pays particular attention to its personal relationships with a firm's senior management and whether management can, in its opinion, be trusted. So it is important at all times to be candid and truthful. Post-approval events that bring an individual's integrity into question (and therefore question the proper governance of the firm) include:

- criminal conviction(s) for fraud etc
- adverse findings in a civil court
- being the subject of a disciplinary hearing or a justified complaint
- involvement with a company that has been refused registration or had its authority to trade revoked
- resigning after being asked to resign from a relevant body.

Enforcement

In the six month period ending December 2007, the FSA issued eight enforcement notices on firms and/or individuals for breach of Principle 1. **In every case, a ban resulted.**

The reasons were varied and included:

- paying premiums into a personal bank account
- misleading the FSA
- not being candid with auditors
- dishonest and untruthful behaviour
- hiding a loss-making position.

"We will use our powers to prosecute matters as criminal offences and to restrain the proceeds of crime"

FSA Business Plan 2007/8

CEO's 10 point Integrity Checklist

- ✓ I have articulated my firm's culture and defined what it means
- ✓ My firm's culture is understood by ALL employees and demonstrated by their behaviours
- ✓ New employees are only recruited if they appear to fit with our culture
- ✓ My firm has developed and promoted a code of business conduct that aligns its culture with its strategic aims and vision
- ✓ All my employees understand what is and what is not acceptable behaviour
- ✓ Inappropriate behaviour is covered under our employment policies
- ✓ Appropriate agreements are in place with all stakeholders. These include provisions for dispute resolution and ending our relationship
- ✓ Measures of employee performance and reward include adherence to our code of business conduct
- ✓ Appropriate checks are made on the fitness and propriety of all employees pre-employment and on a regular basis thereafter
- ✓ My firm's systems and controls include checks designed to reveal inappropriate behaviour



"We will use enforcement strategically to change behaviour in the industry"

FSA Business Plan 2007/8



Accounting Policy Review

The second in a series of articles by Jessica Wills reveals more of the key accounting policies adopted by brokers. With the FSA pushing for increased transparency, this edition focuses on the trends and issues surrounding revenue recognition and disclosure and the impact that FSA pressure may have on accounting policy disclosure.

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Background to the review

We reviewed the financial statements of 46 of the top 50 UK firms and compared their income accounting policy disclosures to the relevant accounting standards applicable to UK firms – IFRS (IAS No.18) and UK GAAP (FRS 5 – Application note G). During 2005 specific guidance for brokers was issued in the form of Technical Release, TECH; 5/04.

Brokerage revenue recognition disclosure

The main component of most firms' income is commission income. As expected, this showed the greatest variance in the depth and clarity of policies. As a rule these were broadly in line with standards, however, there were a number of policies that showed ambiguity that prevented the reader fully understanding the exact point of recognition.

Examples of these are as follows;

"Credit is taken for earned commissions and fees at the point of which the company becomes contractually entitled to it."

"Commissions and associated fees are recognised in the profit and loss account at the date of the transaction."

"Turnover represents brokerage, fees and commissions which are recognised when the client is charged."

"Brokerage is accounted for at the point a policy is sold."

"Turnover is recognised when it falls due."

"Turnover comprises earnings on insurance transactions recognised when policies are established for insured parties and fees and commission raised in the year."

Brokerage Revenue Recognition	% of brokers
When policy/debit note issued.	19.6
When the policy placement is substantially complete.	8.7
On inception date.	19.6
At the earlier of inception date and when the policy/debit note issued.	4.3
At the later of inception date and when the policy/debit note issued.	4.3
At the later of inception date and when the policy placement is substantially complete.	34.8
When the policy placement is substantially complete and incepted.	2.2
When the premium is closed to the underwriter in the company's books.	2.2
No accounting policy disclosed.	4.3

Fee revenue recognition disclosure

Only seven firms make any distinction between brokerage and fee revenue recognition, a surprising finding given the trend towards this type of remuneration. In accordance with FRS No. 5 fees should be recognised as the service is performed.

Fee Revenue Recognition	% of brokers
When the right to consideration arising from contractual performance is earned.	14.3
In the period they relate to and can be measured with reasonable certainty.	42.8
In accordance with the performance of the terms of the contractual arrangements with the client.	14.3
On a periodic basis when the consideration due is confirmed by the third parties.	14.3
At the point of sale.	14.3

Binding authority revenue recognition disclosure

Only five firms disclose their policy in respect of binding authority revenue recognition. FRS No. 5 requires this should be recognised on the basis of the inception of the underlying attachments. Four firms recognise the revenue on a periodic basis when the consideration due is confirmed by third parties, and one firm recognises the revenue when risks are declared as attaching to relevant policies.

Profit commission revenue recognition disclosure

Only six firms disclose their policy on profit commission revenue recognition. FRS No. 5 states profit commission revenue should be recognised when the right to profit commission is established (normally when the contract becomes effective). However, profit commission should only be recognised when a reliable estimate can be made.

Profit Commission Revenue Recognition	% of brokers
When notified/confirmed by underwriters.	33.3
When notified/confirmed by underwriters and can be reliably estimated.	50.0
When it can be determined.	16.7

Post placement activities

The deferral of revenue from contractual post placement activities such as policy wordings/documentation and claims handling is a key area of judgement and estimation. The range of wording used is fairly small but 16 firms do not disclose their policy. In a key area, often reviewed by HMRC, few firms provide detailed commentary on the methodologies and assumptions used to determine the amount of revenue to be deferred.

Post Placement Activities	% of brokers
Deferred to match costs of services.	3.4
Deferred to match contractual obligation of future servicing.	89.9
Deferred and recognised in the periods in which post placement activities take place.	6.7

Instalment businesses

43 firms do not disclose their policy on revenue on instalment business. FRS No. 5 states that all revenue on instalment business should be recognised upfront and this policy was adopted by those firms reviewed that did disclose their policy.

Actions

Overall, in our experience, the revenue recognition accounting policies adopted by firms are broadly consistent with accounting standards and across the industry. However, this review has shown that disclosure of these policies is diverse and the level of detail varies greatly.

1. Improve revenue recognition disclosure

Given the general trend towards transparent disclosure within financial statements and more scrutiny of income disclosure to clients, firms might consider enhancing their revenue recognition accounting policy disclosures. Firms might consider enhancing disclosure in the following areas, particularly where these represent a high proportion of total revenue:

- fees
- binding authorities
- profit commissions
- methodologies and assumptions for determining the deferral of income in respect of post placement activities
- instalment business.

2. Act now!

Disclosing commission to clients on a consistent and transparent basis is likely to become obligatory for firms. Thinking about financial statement revenue recognition now will make the transition to fuller commission disclosure to clients easier: firms will have already discussed many of the complex components that go into making up their income. In addition, we may see industry guidance relating to mandatory commissions disclosure driving firms to change the way they disclose their revenue recognition accounting policies in their financial statements.

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Littlejohn is an independent, top 30 firm of chartered accountants and business advisors. Leaders in providing accountancy and audit services to the London insurance market, the firm has operated in the sector for over a century. Littlejohn's specialists help clients to overcome the challenges faced by the industry through a comprehensive commercial and technical understanding of its workings, and a high level of partner involvement. Clients range from owner-operated firms to some of the biggest names in the broking world.

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