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# On the road ahead

IFRS top ten issues in insurance industry



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The challenges of converting to IFRS will be different for every company. However, not surprisingly, particular industries tend to experience some common themes and issues. For the insurance industry overall, these are likely to be the top ten recurring areas of particular significance, and likely differences from Canadian GAAP.

# 1

## Insurance contracts – measurement principles

Insurance companies have unique challenges given there is not presently a fully developed IFRS standard for insurance contracts and in all likelihood Phase II of the project underway to develop it will not be in place when Canadian insurance companies adopt IFRS. The Discussion Paper (“DP”) released by the IASB in May 2007 attracted many comments and there are divergent views from different parts of the world on the appropriate accounting framework for insurance contracts. The expectation is that the earliest that an exposure draft will be published is 2009 with a final standard following a year later and implementation in 2013 although this timeline could change as the project progresses.

The main proposition in the DP is that all insurance liabilities (including life, non-life, direct insurance and reinsurance) should be measured at current exit value (“CEV”) using the following three building blocks:

- **Current estimates:** explicit, unbiased, market-consistent, probability weighted and current estimates of the contractual cash flows;
- **Time value of money:** current market discount rates that adjust the estimated future cash flows for the time value of money; and
- **Margins:** an explicit and unbiased estimate of the margin that market participants require for bearing risk (risk margin) and for providing other services, if any (service margin).

CEV is defined as the amount an insurer would expect to pay at the reporting date to transfer its remaining contractual rights and obligations immediately to another entity. Typically, the CEV of an insurance liability is not observable (i.e. as a readily available value in a marketplace).

The CEV approach proposed in the DP raises many questions the industry will need to consider and it is important that market participants continue to provide input in the development of the principles into a standard across the insurance industry. This, along with the emergence of detailed guidance, will no doubt generate much debate as insurers, users of accounts, industry regulators and other accounting standard setters deliberate and comment on the proposals.



The key issues for Canadian insurance companies include:

- the application of discounting for insurance cash flows and the selection of the related discount rates which are based on the characteristics of the liability rather than on the related investment returns, as currently used under Canadian GAAP;
- significant restrictions on considering future policyholder behaviour creates particular issues for certain life insurance products in Canada;
- the requirement to unbundle deposit and service components unless interdependent and not measurable separately;
- the requirement to consider all possible cash flows in deriving probability weighted expected mean average cash flows;
- development of industry market practice for the determination of market consistent risk margins and service margins;
- whether an overall insurer's risk margin should take into account product portfolio diversification;
- the risk and service margins established at inception may, in certain circumstances, allow an insurer to report a profit or loss on inception of the insurance business;
- the volatility of insurer liabilities and the resultant profits and losses that will arise as market consistent discount rates and estimates of risk and service margin change after inception; and
- whether the CEV should reflect the credit characteristics of the insurer or be estimated on a consistent basis by all insurers.

Insurers face considerable ambiguity given the current absence of an international actuarial standard setting body with binding authority and it is unclear at this point as to how such ambiguity might best be managed. Canadian experience, since the early 1990's, evidences close coordination between actuaries, accountants and regulators. This has resulted in a body of actuarial standards and guidance that promotes an appropriate level of consistency in Canadian actuarial practice. It is currently unclear how consistency will be achieved under IFRS. This question goes to the very heart of the prime objective of the IFRS insurance project.

The proposals would also have a number of collateral impacts. The introduction of new accounting systems to determine CEV will be costly but they will likely be more cost effective if they can be utilised throughout the business, not just for financial reporting. Insurance companies would also need to educate users of financial statements on the implications of applying this new reporting model to their particular business. Canadian insurers should continue to monitor developments and assess potential implications as the project progresses.

# 2

## Product classification

The existing standard (IFRS 4) will require a significant amount of effort to identify those contracts that meet the definition of insurance contracts under IFRS, particularly for companies with life insurance products that contain investment features and reinsurance contracts that do not contain significant insurance risk as defined in IFRS 4. Contracts could be considered investment contracts or service contracts that will follow the measurement principles in IAS 39 (Financial Instruments) or IAS 18 (Revenue Recognition). Contracts that meet the definition of an insurance contract will continue to be accounted for under previous Canadian GAAP methods subject to some limitations. There will be system implications and the changes will affect recognition, measurement and disclosures for contracts moving outside the previous insurance accounting methods.



# 3

## Insurance contracts – financial statement presentation and disclosures

The disclosure requirements under IFRS 4 will result in significant additional disclosures in the financial statement notes of Canadian insurance companies compared to current practices. The experience of many European insurance companies was that the length of their financial statements increased significantly with many doubling in length. The increased disclosure requirements include detailed disclosures relating to the amounts recognized and extensive risk management disclosures. IFRS 4 also requires reinsurance recoverable to be presented as an asset on the balance sheet as opposed to netting it against the insurance liability and there is an explicit requirement to assess it for impairment periodically.

This will require significant effort and a thoughtful approach to providing the appropriate level of qualitative and quantitative disclosures. There will be new information provided and some companies may require lead time to be able to access the information required or make system changes to accommodate the increased disclosure requirements.

# 4

## Insurance contracts – embedded derivatives and unbundling

There could also be significant effort involved in assessing whether there are any embedded derivatives that will need to be bifurcated from insurance contracts and accounted for under IAS 39 at fair value, particularly for certain life insurance products and reinsurance contracts. Under current Canadian GAAP, contracts issued by insurance enterprises are exempt from the requirements to bifurcate embedded derivatives. The conversion to IFRS will require insurance contracts and contracts determined to be investment contracts under IAS 39 to be assessed for embedded derivatives.

There are fairly limited requirements in IFRS 4 relating to unbundling of deposit components. If an insurance contract contains both an insurance component and a deposit component, unbundling the components is permitted in some circumstances and required in others.



# 5

## Insurance contracts – changes in accounting policies

Under IFRS 4, there is the potential for introducing changes in accounting policies and practices in the interim period between 2011 and the promulgation of the Phase II standards. Under IFRS 4, “an insurer may change its accounting policies for insurance contracts if, and only if, the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. An insurer shall judge relevance and reliability by the criteria in IAS 8.”

Some insurers may want to make changes at the first implementation date of IFRS; perhaps to move closer to the anticipated Phase II standards and; perhaps to offset perceived deficiencies in the first transition. This raises the potential for different changes being made by insurers. The potential for changes, let alone consistent changes, already concerns regulators and will potentially concern rating authorities, investment analysts and others, because they base solvency tests and other analysis on financial statement numbers.



# 6

## Impairment

The impairment guidance in IAS 36 is applied to all investment properties carried at cost, as well as to non-investment property, plant and equipment, goodwill and intangibles and the impairment guidance in IAS 39 is applied to financial instruments.

Compared to Canadian GAAP, IAS 36 requires a different measurement approach. Impairment is only recognized under Canadian GAAP if an asset or group of assets' carrying amounts exceeds the undiscounted cash flows expected to be generated through use of the asset. Under IFRS, impairment losses are recorded if the asset or cash generating unit's carrying amount exceeds fair value less costs to sell and value-in-use. Both fair value and value-in-use will likely be less than undiscounted cash flows, meaning that impairment is triggered under IFRS more often than under Canadian GAAP. The IAS 36 model also presents other differences from Canadian GAAP in the mechanics of how impairment is measured. IAS 36 allows the subsequent reversal of impairment losses for assets other than goodwill if the recoverable amount later increases; impairment write downs are not reversed under Canadian GAAP.

Under IAS 39, impairment losses on available for sale debt securities can be reversed in a subsequent period up to original cost if the fair value increases and the increase can be objectively related to an event occurring after the impairment loss was recognised in profit or loss. Impairment losses on available for sale equities cannot be subsequently reversed through profit and loss.



# 7

## Financial instruments

Although the basic principles of IFRS and Canadian GAAP are similar, there are a number of specific differences.

### **Fair value option**

IAS 39 includes conditions that must be met to apply fair value through profit and loss measurement that are not included under Canadian GAAP but are similar to the OSFI guideline D-10 requirements (the “Fair Value Option”) applicable to insurance companies. However, the OSFI guideline also requires that for property and casualty insurance companies the assets designated under the Fair Value Option be approximately equal to the amount of net unpaid claims and have approximately the same duration as the net unpaid claims to meet the criterion. Insurance companies should monitor this for any changes as OSFI is planning to review its accounting guidance in light of the conversion to IFRS.

### **Measurement**

Measurement principles also differ for some aspects of guarantee contracts and available for sale securities (“AFS”). For example, many P&C insurers designate their investments as AFS and many life insurance companies designate their surplus investments as AFS. The foreign currency changes on those securities are recognized in net income rather than recognizing them in other comprehensive income under the Canadian GAAP. Another example is that IFRS requires all AFS financial assets to be measured at fair value (unless fair value is not reliably determinable) whereas Canadian GAAP requires non-quoted AFS equity instruments to be measured at cost.

### **Derecognition – structured settlements**

Structured settlements are often used by automobile insurance companies to settle claims that have ongoing periodic payments. The claim obligations are derecognized under current Canadian GAAP if the criteria outlined in OSFI Guideline D-5 are met. Insurers will need to review the terms of their structured settlement arrangements to assess whether the derecognition criterion outlined in IAS 39 are met to continue to follow the current Canadian GAAP approach.

### **Hedging**

IFRS does not permit some hedging strategies currently permitted under Canadian GAAP, and does not allow the use of the “critical terms match method” of assessing hedge effectiveness. However, some strategies not allowed under Canadian GAAP are permitted under IFRS, such as combining a derivative and non-derivative as a hedging item, or macro hedging of fair value interest risk for a portfolio.

### **Liabilities and equity**

Insurance companies will need to carefully assess the treatment of their financing arrangements under IAS 32 as the treatment of convertible and compound instruments, preferred shares, etc. could be different depending on the facts. For example, IAS 32 emphasizes the residual nature of equity and places the primary emphasis on measuring the liability component – Canadian GAAP does not prescribe any particular method for assigning a carrying amount to liability and equity elements contained in a single instrument. A conversion option not in the entity's functional currency is an embedded derivative under IAS 32 – this is not addressed under Canadian GAAP.

# 8

## Real estate

IAS 40 and IAS 16 will be of particular interest to insurance companies with significant real estate holdings. IAS 40 permits entities to adopt a cost model or a fair value model, under which an investment property (a property held to earn rentals or capital appreciation, rather than to produce or supply goods or services, for administrative purposes, or for sale in the ordinary course of business) is measured after initial measurement. Changes in fair value under the fair value model are recognized in the income statement. If the cost model is chosen to account for investment properties, the insurance company must disclose the fair values of its properties. These alternatives differ from the current moving average market method followed under Canadian GAAP by life insurance companies.

There also may also be some properties that are currently accounted for as real estate investments under Canadian GAAP by life insurance companies that will meet the definition of own use property under IAS 16 that will be accounted for as property, plant and equipment at amortized cost or using the revaluation model (fair value with changes in fair value recognized directly in equity) under IFRS.



## First-time adoption of IFRS

Insurance companies will need to work through a range of specific issues under IFRS 1, including in particular the extent to which they take advantage of the available exemptions for first-time adopters. These include exemptions from retrospectively restating all past business combinations and an exemption that allows the ability to use fair value measurements as a deemed cost in certain circumstances. IFRS 4 also contains some specific transitional provisions that apply on first-time adoption.

There is also a requirement to disclose detailed reconciliations of the balance sheet, income statement, statement of cash flows and equity between Canadian GAAP and IFRS for the year of adoption of IFRS with comparatives for the prior year. For companies preparing quarterly financial statements, these disclosures are also required in the quarterly financial statements.

An insurance company's financial statement presentation will also need to be assessed to comply with the requirements of IAS 1 – Presentation of Financial Statements which has some differences compared to current Canadian GAAP practices followed by insurance companies.

# 10

## Other areas

The following presents a few other areas that should be considered; their relative significance will depend on an insurance company's activities in these areas.

### **Business combinations/ Consolidations including special purpose entities**

Those insurance companies active in mergers and acquisitions will be keenly interested in IFRS 3 and developments in business combinations accounting. IFRS 3 differs from current Canadian GAAP in numerous specific respects although the area is in the process of being converged. The core definition of control is not the same between IFRS and Canadian GAAP and could lead to different conclusions in some fact situations. The measurement of shares issued as purchase consideration is based on the published price at the date of exchange and this likely will be later than the Canadian GAAP measurement date in many circumstances. IFRS also differs from Canadian GAAP in that it does not permit liability recognition of termination costs as part of the purchase price equation. IFRS also requires that transaction costs be expensed rather than recorded as part of the cost of purchase as is the current practice under Canadian GAAP.

For special purpose entities, SIC-12 sets out a fundamentally different approach under IFRS. SIC-12 focuses on control rather than on the "primary beneficiary" – driven approach of AcG-15; this could generate different results in many cases.



### **Leasing**

The basic accounting models of CICA 3065 and IAS 17 are similar, although there are numerous subtle differences. IAS 17 has a somewhat broader scope of application and attempts to take a more principles-based approach to determining whether substantially all of the risks and rewards incidental to ownership have been transferred under a particular arrangement. The calculations of minimum lease payments and their present value and of the interest rate implicit in the lease could be different under IAS 17, as well as the treatment of initial direct costs. The “bargain purchase option” criterion does not exist under IAS 17. Canadian GAAP is more prescriptive than IFRS on when a lease of land and buildings is considered to be one element rather than two; various other detailed guidance included in Canadian GAAP (such as on lessor accounting for a lease cancellation) is not included under IFRS. There are also differences in the accounting for sale-leasebacks under IFRS versus Canadian GAAP.

### **Share-based payments/related parties**

Although the models of IFRS 2 and CICA 3870 are broadly similar, there may be differences in areas including awards calling for settlement in cash and in share-based non-employee transactions.

### **Employee benefits**

IAS 19 has a broader scope than CICA 3461, addressing benefits provided to employees during their active employment as well as subsequently. The accounting model for long-term benefits is similar but with many specific differences. The most prominent is perhaps the option under IAS 19 to recognize all actuarial gains and losses outside profit and loss (in other comprehensive income) in the period in which they occur. Under IAS 19, the expected return on plan assets must be based on market expectations; it cannot be based on “market-related” values. IFRS contains less explicit guidance than Canadian GAAP on the accounting for termination benefits.

For more information please visit:

[www.deloitte.com/ca/IFRS](http://www.deloitte.com/ca/IFRS)



# Contacts

## Industry leader

Neil Harrison  
National Leader IFRS for Insurance Industry  
416-601-6307  
nharrison@deloitte.ca

## Leadership team

### Edmonton

Dave Wilson  
780-421-3792  
davemwilson@deloitte.ca

### Montreal

Nick Capanna  
514-393-5137  
ncapanna@deloitte.ca

Martin Castonguay  
514-393-5014  
mcastonguay@deloitte.ca

Alain Côté  
514-393-5317  
acote@deloitte.ca

### Quebec

Jean Lamy  
418-624-5359  
jlamy@deloitte.ca

Richard Simard  
418-624-5364  
risimard@deloitte.ca

Clarence Turgeon  
418-624-5366  
cturgeon@deloitte.ca

### South Western Ontario

Dlane Gilpin  
519-650-7720  
dgilpin@deloitte.ca

### Toronto

Kerry Danyluk  
416-775-7183  
kdanyluk@deloitte.ca

Doug Gray  
416-601-6399  
dougray@deloitte.ca

David Ross  
416-601-6211  
davross@deloitte.ca

Graham Segger  
416-601-6198  
gsegger@deloitte.ca

### Vancouver

Shirley Wolff  
604-640-3022  
shwolff@deloitte.ca

### Winnipeg

Tamara Schock  
204-926-7654  
tschock@deloitte.ca



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