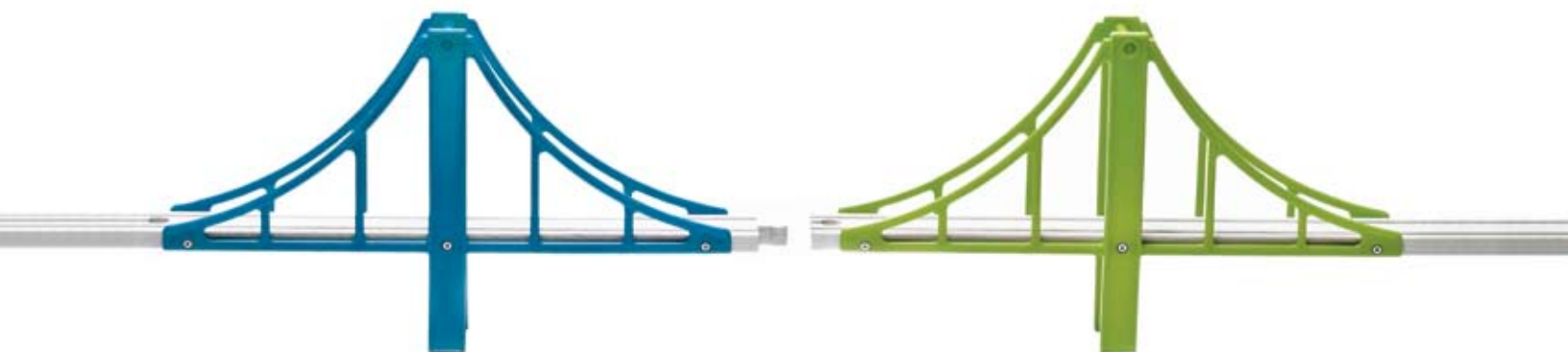


Canadian insurance industry A clear path to IFRS conversion



Over the past 18 months, navigating the challenges and changes presented by the world's markets and economies has been difficult, to say the least. No industry has felt this more than financial institutions. In light of the current economic uncertainty, it would be a natural response to delay your International Financial Reporting Standards (IFRS) conversion. You need your best minds focused on navigating the daily challenges, not on some future mandate. However, the Canadian conversion date is rapidly approaching and the challenge of IFRS conversion will not abate.

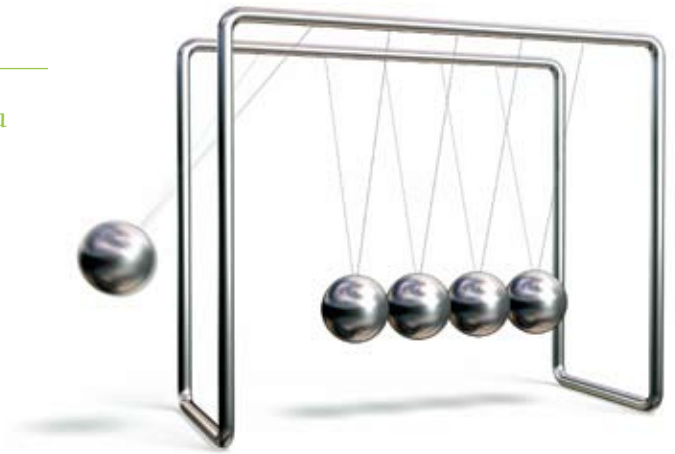
Technical accounting issues for the Canadian insurance industry

IFRS poses technical accounting challenges to the insurance industry. When addressing these challenges, you must not lose sight of the potentially significant effects those changes may have on actuarial, tax, regulatory matters, systems and processes (including internal controls over financial reporting). The table below highlights some key IFRS challenges that are particularly important to the insurance industry; the majority of these challenges arise from the existing and developing IFRS standards for insurance contracts (IFRS 4):

	Accounting considerations	Other considerations
Insurance contracts – product classification	<ul style="list-style-type: none"> Only contracts that meet the definition of an insurance contract under IFRS 4, by containing significant insurance risk, are classified as insurance contracts. Contracts that do not contain significant insurance risks could be considered investment contracts or service contracts, and need to follow the measurement principles in IAS 39 (Financial Instruments) and IAS 18 (Revenue Recognition) respectively. Contracts are classified based on economic substance as opposed to legal form. 	<ul style="list-style-type: none"> Significant effort may be required to examine contracts to enable proper classification of products, particularly for companies with life insurance products that contain investment features and reinsurance contracts. Some companies are considering the costs-benefits of modifying existing product features to achieve desired insurance contract classification. Changes will affect recognition, measurement and disclosures for contracts moving outside the insurance contract classification.
Insurance contracts – Financial Statement presentation and disclosures	<ul style="list-style-type: none"> IFRS 4 requires detailed disclosures relating to the amounts recognized, as well as extensive risk management disclosures. Reinsurance assets, liabilities, income and expenses are required to be presented gross in the financial statements as opposed to being netting against the insurance amounts. 	<ul style="list-style-type: none"> A thoughtful approach and significant effort will be required to providing the appropriate level of qualitative and quantitative disclosure. Companies should plan ahead to obtain the new information required to be disclosed under IFRS.
Insurance contracts – Embedded derivatives and unbundling	<ul style="list-style-type: none"> IFRS will require insurance and investment contracts to be assessed for embedded derivatives. Embedded derivatives may need to be bifurcated from insurance contracts and accounted for under IAS 39 at fair value. If an insurance contract contains both an insurance and deposit component, unbundling the components is permitted in some circumstances but required in others. 	<ul style="list-style-type: none"> Guarantees and options in insurance contracts will need to be inventoried to identify those that are embedded derivatives. Unbundling could be used strategically to achieve certain financial statement presentation or accounting results.
Insurance contracts – Measurement approach	<ul style="list-style-type: none"> Insurance accounting guidance is under development in IFRS 4 Phase II of the insurance contracts project. The most significant aspect of Phase II is the decision on the measurement approach for insurance liabilities. Basic features of the measurement approach under Phase II of IFRS 4 include: <ul style="list-style-type: none"> Use estimates of financial market variables consistent with market prices; Use explicit current estimates of the expected cash flows; Reflect time value of money; and Include explicit margins. Other important issues that still require consideration include: <ul style="list-style-type: none"> Criteria for the selection of an appropriate discount rate; How participating contracts will be accounted for; Whether insurance liabilities should be measured by contract, by portfolio, or on some other wider basis; Consideration of future policyholder behaviour for certain life insurance products. There are a number of areas that will be finalized with the publication of the exposure draft expected for late 2009 or early 2010, followed by the final standard in 2011, which will likely not be effective prior to 2013. 	<ul style="list-style-type: none"> IFRS will likely introduce the potential for more volatility of insurance liabilities with resultant profits and losses that will arise as market consistent discount rates and estimates of risk and service margin change after inception. Insurers will need to carefully consider hedging strategies and investment accounting classifications. Model under development has similarities to current Canadian model although there are some significant differences: <ul style="list-style-type: none"> Discounting based on characteristic of liability differs from discount rate linked to investment portfolio under Canadian GAAP Explicit risk and service margin Use of probability weighted cash flows Unbundling requirements Potential restrictions on policyholder behaviour Reflecting own credit risk The changes could have significant implications for systems and processes, as well as hedging programs, Asset Liability Management programs and reinsurance. Insurance companies will need to address issues relating to a phased implementation for insurance accounting – IFRS in fiscal 2011 and Phase II of Insurance Contracts in a later year (likely 2013 or later).
Financial instruments	<ul style="list-style-type: none"> Amendments to financial instruments standards (IAS 39) are under development. Objective of project is to simplify accounting for financial instruments. Proposed new amortized cost (AC) category includes financial instruments that have “basic loan features” that are managed on a “contractual yield basis”. Revised standards for classifications and measurement, impairment and hedging are expected to be finalized by 2010. Effective date expected to be 2012; early adoption expected to be permitted, although for insurance companies, this may not be permitted by the regulator. 	<ul style="list-style-type: none"> Hedging relationships may need to be re-documented to comply with IAS 39 and this will need to be completed by the IFRS transition date to continue with hedge accounting. The proposed elimination of the available-for-sale classification for equity instruments could increase accounting volatility since it may force insurers to account for their equity portfolios at fair value through profit and loss (FVTPL). Classification requires interpretation of “basic loan features” and “contractual yield basis”. Potential to shift measurement of a significant number of assets to AC. The proposed new AC category for basic fixed interest rate bonds could produce a larger accounting mismatch as IFRS Phase II will likely require insurance liabilities to be constantly revalued in line to current market interest rates. Early adoption of IAS 39 could be challenging given potential changes in hedging and impairment guidance. Challenges with managing multiple transition and implementation dates (e.g. First time adoption, revised IAS 39, Phase II of IFRS4). Asset designations in light of requirements of IFRS4 Phase II will need to be considered.

These are just a few of the key accounting considerations facing the insurance industry. Other areas that may have a significant impact include first time adoption (IFRS 1), financial statement presentation and disclosure for segregated funds, real estate as either investment or own-use property, business combinations, derecognition of financial instruments, special purpose entities, impairment of assets, employee benefits, share based payments, income taxes and leasing.

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More than just accounting

Without question, IFRS will affect the general ledger and the financial statements. But in a relative sense, the accounting and financial reporting may be the easy part. How the non-accounting aspects of the conversion are managed may be a far more accurate indicator of success. Other areas requiring particular attention are below:

	Challenge	Deloitte response
Human Resources	<p>Conversion will place increased demands on your personnel, which may come at a time when you are least able to manage it. IFRS 4 Phase II will likely intensify the talent shortage insurance companies face.</p> <p>Compensation plans may also be based on Canadian GAAP results.</p>	<p>This issue can be addressed through proper planning and anticipating resource needs, hiring qualified personnel and training programs to ensure key personnel become proficient in IFRS. Compensation plans will need to be re-evaluated to manage the impact of changing financial statement inputs.</p>
Tax	<p>For the insurance industry, tax accounting differences go beyond the standard tax matters and also include matters such as pre-tax accounting changes on tax methods, global planning strategies, and tax information systems.</p>	<p>One of the most important considerations for the insurance industry is the maintenance of adequate regulatory capital. Deferred tax assets, subject to certain conditions, limitations, and restrictions, are included in the regulatory capital calculations. Many accounting adjustments required on conversion to IFRS can also have an impact on the amount of deferred tax recorded. Accordingly, the impact on regulatory capital needs to be considered.</p>
Treasury	<p>The insurance industry may need to assess the need to revise debt terms for covenants based on Canadian GAAP metrics or financial results that no longer make sense or are no longer attainable under IFRS.</p>	<p>As a result of the changes to the balance sheet and the income statement upon conversion, some hedging or asset liability management strategies may no longer be efficient and effective and require attention. Plans should be put in place to renegotiate finance arrangements as necessary.</p>
Information Technology	<p>Systems may need to be evaluated and adjusted. Specifically, system changes may be required to accommodate the increased disclosure requirements; configuration may be needed for the new product classification. IFRS may increase the need for documented assumptions and sensitivity analyses, expanding the scope of information managed by insurance financial systems.</p> <p>The changing IFRS landscape for the insurance industry will continue to put pressure on technology requirements.</p>	<p>With the numerous changes in accounting standards, the introduction of new accounting systems to address the needs of IFRS will be costly. These changes will likely be more cost effective if information can be utilized throughout the business, not just for financial reporting.</p> <p>There should also be explicit consideration in process re-engineering and system controls with the implementation of new systems.</p>
Actuarial and Claims Management	<p>Phase II of the insurance project under IFRS will likely require changes to actuarial systems and processes. Insurers will need to become comfortable with providing appropriate assumptions, whether market consistent or portfolio-specific, probability weighted cash flows, liability driven discount rates, service margins and other areas where differences exist compared to current practices.</p>	<p>It is important to become comfortable with new techniques and work to continually test models under new conditions and refine them. The aggregation and integration of both internal and external data into a consistent format that enables analysis would be necessary for insurers to be able to perform certain estimates under IFRS.</p>
Performance and Business Decisions	<p>IFRS may introduce significant changes in the accounting and/or presentation of information used in performance and business decisions in various other areas of companies including: board governance; investor relations, mergers and acquisition, product design, pricing and offerings.</p>	<p>A plan and communication strategy should be developed for identified key stakeholders, considering the impact of IFRS on key performance indicators, providing appropriate levels of training, managing end-user expectations, and potentially leveraging additional information available to management from adopting IFRS to provide new business insights.</p>

Resources

Deloitte has extensive IFRS experience serving the insurance industry both locally and internationally (where many have already transitioned to IFRS). With thousands of IFRS-experienced professionals in our global network, we provide a comprehensive array of services and, as a multidisciplinary organization, are positioned to assist with the wider IFRS issues as well as the accounting.

Deloitte offers assistance with:

- Evaluating the potential effects and assessing readiness for IFRS conversions
- Implementing IFRS conversions, providing support with technical research, project management, and training
- Addressing the wider implications of IFRS in such areas as actuarial, tax, finance operations, regulatory capital, technology and valuation

Deloitte's insurance industry practice

As a recognized leader in providing audit, tax, consulting and financial advisory services to the insurance industry, our clients include life, reinsurance, property & casualty insurance companies in Canada and around the world.

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