

Unlocking the vagaries of insurance accounting*

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Transforming the accounting for insurance contracts

The move to International Financial Reporting Standards (IFRS) around the world will dramatically alter the way insurers present their business and how they are measured by analysts, investors and other key stakeholders. Over the last few years, much progress has been made toward global commonly accepted accounting standards and numerous IFRS have been developed.

The complexity of accounting for insurance contracts compelled the International Accounting Standards Board (IASB) to take a two-phase approach in order to develop a comprehensive IFRS for insurance contracts. The first step was the issuance of IFRS 4, which was limited in scope but provided insurers that were required to report under IFRS in 2005 for the first time with a universal definition of an insurance contract.

The latest development under Phase II of this project is the long-awaited Discussion Paper: Preliminary Views on Insurance Contracts, issued by the IASB

(www.iasb.org) on May 3, 2007. This document sets out the preliminary views on the measurement and recognition of insurance contracts and financial instruments with discretionary participating features. The IASB invites all interested parties to provide comments on the proposals by November 16, 2007.

The IASB's proposals on insurance contracts break new ground in several key areas and could have an important bearing on a number of other IFRS projects, including revenue recognition and the classification of instruments as debt or equity.

To achieve the objectives of uniformity and transparency that are expected from globally accepted accounting standards, insurers will have to work together to enhance the clarity, consistency and usability of their financial statements. This is especially true in areas where the new regime leaves insurers substantially free to choose the nature or format of financial statement presentation.

The following highlights some key proposals included in the discussion paper on insurance contracts.

A single approach for measuring insurance contracts

The discussion paper proposes a single approach to account for life, property and casual and reinsurance contracts. It will be based on three building blocks:

- i. an explicit, market consistent, unbiased, probability weighted current estimate of future cash flows;
- ii. a discount rate based on market interest rates to discount these cash flows; and
- iii. an explicit and unbiased estimate of a margin that another party would require to bear risk (risk margin) and to provide services (service margin) if there are any.

The expected value would be based on an evaluation of all possible outcomes, which could create additional demands on an insurer's existing data and modelling

systems. Even if these capabilities are available, insurers will need to make certain that the analysis conforms to standards that facilitate auditing.

The IASB tentatively favours the measurement of these three building blocks using a “current exit value” (exit value) model (i.e. assuming a hypothetical transfer of the contract to another party) rather than using the premium as its basis of valuation. As the exit value is not linked to the premium received from the policyholder, it could potentially lead to an initial gain at the inception of the contract. In both entry and exit value models, the insurer could recognize day one losses if it underprices its premiums. The single approach methodology is currently not in place in Canada and certain components are opposed by several North American and European lobby groups.

Current market discount rates

Current market discount rates are to be based on market risk-free interest rates matching the characteristics of the contractual cash flows, including

timing, currency and liquidity. The insurer’s investment strategy is not relevant. While Canadian insurers are used to discounting reserves for insurance contracts, the discount rate is tied to an insurer’s investment returns rather than a “market” rate, as articulated in the IASB’s proposals.

A margin for risk and service

In the exit value model, the explicit risk margin reflects the allowance for uncertainty that a nominal market participant would require to take on the transferor’s remaining contractual rights and obligations. In practice, this requires a “proxy” for market observable valuation, based on either a “percentile” or “cost of capital” approach. The IASB does not express a preference for either method.

Under the IASB proposals, the service margin reflects the cost that the insurer would have to pay to transfer the remaining portion of services provided as part of the contract to another party, such as investment management. Both the

risk and service margins would need to include a profit element that a third party would demand for bearing those risks and delivering those services.

Currently in Canada, margins used in the calculation of life insurance reserves are prescribed by the Canadian Institute of Actuaries and required under Canadian GAAP. Canadian property and casualty insurers also include a provision for adverse deviation when discounting their reserves. Depending on the current methodology and assumptions applied, the IASB proposals may yield a much different result.

Other areas of consideration within the IASB’s proposals include:

- Acquisition costs are expensed as incurred. The exit value basis may produce income that would offset acquisition expenses if there are premiums (already received or expected in the future) that policyholders must pay to maintain their right to “guaranteed insurability.”

- Guaranteed insurability is the policyholders' right to receive insurance coverage at a price that is contractually constrained without reconfirming their risk profile. All future premiums that pass this test are included in the current value measurement.
- Policyholder participating benefits can be recognized and measured as a liability based on the existence of either a contractual or constructive obligation. The concept of what is a constructive obligation is under review by the IASB in the context of other projects.

The IASB paper also calls for bifurcation of contracts that contain both insurance and investment components. These may need to be unbundled and measured separately; unbundling is limited to circumstances where the components are not interdependent and can be split on a basis that is not arbitrary.

Making views count

It is clearly important that insurers understand the full implications of these proposals for their business and, based on this appraisal, take the opportunity to provide input to the IASB. While there will be further opportunities for comment following the publication of the exposure draft, the current consultation period offers the best chance to influence the fundamental principles and key practical details of the eventual IFRS Phase II standard.

Progress in implementing IFRS will be best achieved through close co-operation among insurers, the active engagement of preparers and users of financial statements and the IASB. Canadian insurers and regulators should keep a close watch on developments to help ensure that the right methodologies will be selected and applied in the new accounting environment.

Migrating to IFRS – the Canadian context

The accounting of insurance contracts under IFRS 4, which was discussed in the preceding article, is a critical, but certainly not the only component for consideration when migrating to the new accounting standards. The transition from Canadian GAAP to IFRS will not just be a technical accounting exercise; rather, it will present unique challenges as it impacts many other areas beyond an insurer's finance and accounting functions. The impact of the changes may, for example, be felt in the taxation and treasury departments and affect key performance indicators, bonus structures and debt covenants.

The transformation of the accounting basis to IFRS places significant responsibility on management. Results of operations, forecasts and new business developments

will have to be communicated effectively to the market in the new accounting and reporting language. Accordingly, business areas that do not normally concern themselves with implementing new accounting standards, such as investor relations, will need to be involved in the IFRS conversion plan.

PricewaterhouseCoopers' (PwC) surveys have shown that the global and/or European companies that have been most successful in implementing IFRS are those that have adhered to a comprehensive conversion plan. The systems, processes, policies, procedures and training programs of such companies have been designed to embed IFRS into their daily operations, internal management information systems and the mindset of staff.

Early planning is key

The fundamental changes to the accounting basis require much preparation to ensure a smooth adoption and conversion process. While the implementation date of 2011 that has been proposed by the Accounting Standards Board (AcSB) may seem far in the future, insurers can't afford to underestimate the time required for migration to IFRS. As early as December 31, 2008, companies will be required to disclose their IFRS convergence plan and anticipated effects.

Based on PwC's experiences with European insurers, a comprehensive, three-phased conversion approach has proven to be sustainable and effective.

The universal acceptance of IFRS standards as a global basis of accounting received further support with the recent draft rule issued by the U.S. Securities and Exchange Commission. The draft rule will allow non-US companies to file financial results on an IFRS basis and, thus, eliminate the onerous reconciliation to US GAAP.

Phase I: Diagnostic preliminary review

The first step should be a thoughtful scoping exercise that identifies accounting differences between Canadian GAAP and IFRS, determines the impact on the company's financial reporting and creates a platform for early awareness and training of key executives and board members.

The preliminary study should include the following:

- research of financial information;
- initial diagnosis of differences;
- overall organization of implementation exercise;
- estimate of financial and systems impact;
- outline of a work plan; and
- estimate of required resources and costs.

Phase II: Conversion awareness and plan

The complexity of the conversion requires the development of a well-planned communications strategy with key stakeholders concerning the move to IFRS and potential impact. Stakeholders not only include investors and analysts, but extend to executives, board members and employees, who must be trained and educated about the new reporting environment. Assigning appropriate resources to the IFRS conversion project is a critical factor for successful execution of the conversion plan.

The conversion plan must integrate all regulatory and governance requirements faced by insurers. A detailed examination of systems must be undertaken to make informed IT investment decisions

regarding the impact on systems, processes and data. For example, existing reporting templates may have to be expanded to incorporate supplementary data required for additional disclosure under IFRS.

The IFRS conversion effort will be driven by a variety of factors, including the extent of current systems standardization and required system changes, e.g. to old legacy systems. It is also affected by the availability of qualified internal resources, the creation of a dedicated team and/or the reliance on external consultants as well as the complexity and scale of operations.

Last but not least, it is imperative that finance executives stay on top of new accounting pronouncements and developments and revise the

Audit committees should understand who within their organizations is responsible for the implementation of IFRS and how the companies' implementation timetables align with the AcSB's proposed timelines of migrating to IFRS.

conversion plan for the impact of these changes. The AcSB intends to work toward eliminating existing differences between Canadian GAAP and IFRS over the transition period, i.e. between now and January 1, 2011. In its desire to harmonize frameworks, the AcSB may adopt new IFRS that will emerge during this time. Organizations need to be nimble to reflect these changes in their project plans.

Phase III: Embedding IFRS into the organization

The new culture must be incorporated into day-to-day operations. This goes beyond the development of new accounting policies and procedures; it extends from the awareness by investment executives of the impact of the new accounting methodology to training of internal audit, legal and marketing personnel.

Be prepared

PwC surveyed UK insurance companies who in 2005 were required to report under IFRS for the first time. (For more details on this survey, please refer to the Fall 2006 edition of Insurance Review.) One of the key findings showed that most insurers encountered enormous implementation challenges, which often were underestimated in both time and resource requirements. While the conversion effort is not a revolution, it will nonetheless have a deep and wide impact on the organization. This is not a reconciliation process, but rather a replacement of the GAAP accounting basis for financial statements. Insurers should prepare to start early on this road to implementation of the new accounting standards, lest they run out of time.



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Seeing risk from the inside

The impact of IFRS 7 and revised IFRS 4 on insurers' financial reporting

This paper examines key changes to IFRS risk reporting, under which insurers will be required to set out how management itself perceives, measures and manages risk.

The changes offer well-run insurers an opportunity to demonstrate the strengths of their risk management more forcibly at a time when analysts and investors are taking an ever-keener interest in the impact of risk on financial performance.



Reporting under the new regime: A survey of 2005 IFRS insurance annual reports

Providing detailed analysis of the financial statements of 26 large insurance groups, covering different segments of the industry, this survey outlines how IFRS has affected the transparency, consistency and comparability of disclosures relating to the insurance business.

The summary edition of the full report details the key findings of the survey. The first section looks at how companies have adopted IFRS for the first time and their comments on the implications of the move. The second focuses on accounting policies. The full version of the report also includes a third section which considers detailed disclosure requirements.

New GST measures: Costly, complex and confounding

The federal goods and services tax (GST) became more costly and more complex for insurers and other financial institutions (FIs) with the package of measures released by the Department of Finance (Finance) on January 26, 2007. Despite representations that highlighted the high cost and low practicality of the new measures, Finance and the Canada Revenue Agency (CRA) appear determined to implement the full package without any modification. This article provides some background on these measures and an overview of their impact; due to the level of complexity, each FI will need to conduct a detailed review, based on its own circumstances.

Two of the changes included in the release have been forecast by Finance for several years: a new regime governing how much GST an FI can recover and a new set of GST rules taxing services “imported” by FIs from outside of Canada. The third item was a fairly late-breaking surprise—a new and detailed annual information schedule that most FIs will be required to file.

How much GST can FIs recover?

Common ground in all Value Added Tax (VAT) systems, such as the GST, is that tax is recoverable on costs fully attributable to taxable supplies but not recoverable on costs fully attributable to exempt supplies. How much GST should be recovered on costs not fully attributable to either taxable or exempt supplies has been a matter of some debate between FIs and the CRA. The first of the three measures addresses this issue, and replaces a simple guiding principle with a detailed set of rules. The principle in the previous form of the legislation allowed taxpayers to devise a method, calculating a recoverable amount that is “fair and reasonable” and the CRA to audit to that broad principle.

The background is that not until the mid-1990s did FIs in Canada begin to replace very crude revenue-driven recovery methods with more refined methods that viewed costs in a more granular way and so recovered a more appropriate, but higher, amount of GST. It was only at this point that recovery levels approached the intended policy result, i.e. there was no “sticking” GST in the cost of zero-rated, i.e. not exempt, exports.

The new rules introduced by Finance are quite detailed but still incomplete. The legislation sets out five classes of “input” into which all costs must be separated. There are two defined classes of FIs and each must apply a specific treatment to the various classes of “input.” A novel and adventurous aspect of the legislative structure is that the design of the two key methods, which determine recovery for the key inputs, is devolved to the Minister of National Revenue. The new rules generally apply to the first filing year ending after March 2007, so FIs have an urgent need to understand the new methods to be specified by the CRA, but these have yet to emerge.

The first of the two classes of FIs consists of the largest banks, insurers and securities dealers. For this class, unless the FI is able to agree on a special method with the CRA, prescribed GST recovery rates between ten and fifteen percent will be imposed for costs not directly attributable to taxable or exempt supplies. Special method applications must be detailed in writing to the CRA six months before the start of the year of application; otherwise, recovery defaults to the prescribed rate. An election is available allowing use of the current recovery method in the transitional year, which is the first filing year beginning after March 2007.

The second class of FIs does not face imposition of the prescribed recovery rates. However, a peculiar election for this class allows an FI that is a bank, insurer or securities dealer to elect to use the respective prescribed recovery rate, but only if it can demonstrate that its actual entitlement exceeds the recovery calculated by using the prescribed rate. After having calculated its actual entitlement, it can then elect to recover a lesser amount. These elections may be rare.

A detailed analysis should be undertaken by all FIs to understand how the rules will apply and whether an application for a special method should be developed and submitted to the CRA. The uniform consequence of error or inaction will be an increase in unrecoverable GST. The net result is that in order to achieve the intended policy result, i.e. no inherent GST cost for export business, each FI will have to incur significantly increased compliance costs under the new regime.

Imported supplies – a new playing field

The second new measure addresses an issue that is common ground for all VAT systems, but with a Canadian twist. In order to prevent purchasers from avoiding GST cost by sourcing services outside their country of residence, most VAT systems have an “imported service” rule, which requires those that cannot recover all GST incurred to self assess the tax on supplies from outside the territory. This rule removes any disadvantage that would otherwise exist for resident suppliers. Canada, however, went one stage beyond other jurisdictions in that it required self-assessment when services flowed into Canada within one legal entity, i.e. from a non-resident head office to a Canadian branch. The integrity of the original legislative structure was questioned in 2003 and resulted in a Tax Court of Canada decision in favour of State Farm Mutual Auto Insurance Company [2001-2226(GST)G].

The new rules are a late reaction to that Tax Court decision. Instead of simply fixing the deficiencies so brightly illuminated, Finance has instead produced a convoluted replacement structure featuring more than 20 new definitions, departing from the concept of taxation of deemed supplies and embracing a new world of taxing “outlays and expenses” with extensive linkages to the Income Tax Act. The new rules may tax events not captured by the previous structure and there may be some accidental overreach. All FIs straddling the Canadian border will have to pick carefully through these rules to identify the GST self-assessment requirements.

Some aspects of the new rules are retroactive to January 1, 1991, and others are effective from November 2005, when Finance issued a press release heralding a new regime. Sadly, harsh retroactive tax changes aimed at the financial sector in Canada are now so routine, they are unremarkable.

A new annual information return for FIs

The third measure in the package is a new information return that FIs will be required to file annually. This is a very detailed return. While part of this return duplicates income tax filings, the detailed additional requirements include a number of items unlikely to be readily available. This may require costs to modify systems, resorting to estimation and manual workarounds. The difficulties with this return were made known to Finance, but to no avail.

Taken together, the three measures will significantly increase compliance costs for FIs, even if every aspect is fully researched and completed in good time. And any delay or error will only add financial penalties to the already heavy compliance burden.

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