

Making sense of IFRS

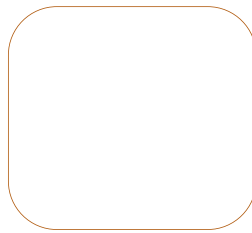
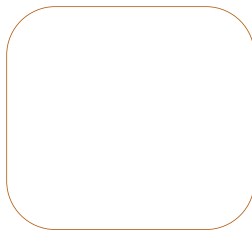
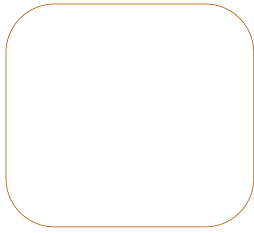
Analysts' perspectives on insurance reporting*



IFRS – Global Reporting Revolution

May 2005

*connectedthinking



The IFRS Revolution

Welcome to the 14th in a series of papers dedicated to discussing International Financial Reporting Standards (IFRS) and their impact on insurers and the users of their accounts.

IFRS went live in January 2005 and it is already clear that the new regime is leading to some significant changes. Recognising this, the Global Insurance Leadership Team has been sponsoring a series of briefing papers focusing on the key commercial and technical challenges, aimed at delivering the information the industry needs to respond to the IFRS revolution.

This paper examines insurance analysts' perspectives on the latest developments in financial reporting and their views on the best way forward. It includes feedback from the latest in an annual series of seminars for insurance analysts, hosted by PricewaterhouseCoopers early in 2005. The results indicate that most analysts believe that IFRS Phase I is only a marginal improvement on what went before and much more work is needed to satisfy their needs as key users of accounts.

I hope that you find this paper thought-provoking and insightful. If you would like to discuss any of the issues addressed in more detail, please speak to your usual contact at PricewaterhouseCoopers or those listed at the end of this paper. We would also appreciate your feedback on this paper, as this helps us to ensure that we are addressing the issues that you are most focused on.

Ian Dilks
Chairman, European Insurance Group

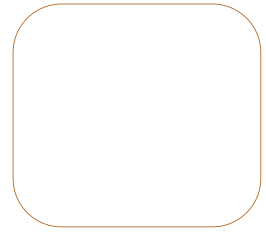
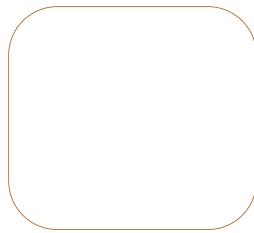
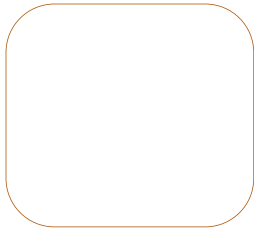
Introduction: The price of uncertainty

Insurance analysts have generally welcomed IFRS Phase I as a step in the right direction. Yet, potential uncertainty and inconsistency could raise the cost of capital for an industry whose financial reporting is already seen, rightly or wrongly, as opaque. How can insurers meet analysts' demands for more open, reliable and comparable disclosure?

IFRS is upon us. Although the accounting principles for insurance contracts in different parts of Europe have remained largely unchanged, far-reaching new disclosure standards will open up insurers' underlying risk, earnings and reserving assumptions to unprecedented scrutiny. Fundamental changes to the valuation rules in areas

ranging from pensions to investments could also have a significant impact on reported equity and earnings.

Initially, at least, there may be a certain amount of upheaval as insurers and the users of their accounts endeavour to make sense of what is a novel and untested system. Moreover, as the new disclosure framework permits a high degree of discretion and even experimentation in how organisations present the required information, it may prove more difficult to compare financial statements between companies and against previous years. Any resulting disparities may raise the cost of capital, especially as many analysts say they already have misgivings about the quality and clarity of insurance reporting.



In January 2005, PricewaterhouseCoopers brought together more than 50 analysts covering the European insurance sector for two seminars to explore their perspectives on financial reporting and how the industry and International Accounting Standards Board (IASB) could better meet their needs as key users of accounts. The January seminars, the second of which was jointly hosted by Lehman Brothers, are the latest in an annual series.

Polling of the analysts carried out during both seminars found that more than 80% believe that IFRS Phase I will improve financial reporting, though for most only 'marginally'. More than 90% feel that the additional disclosures will be at least 'somewhat' helpful. Looking to the current alternatives, most believe that the new European Embedded Value (EEV) framework could prove more useful than Phase I and

what went before, though at this early stage some are concerned about EEV's practical application. Looking to the future, most support an eventual Phase II based on fair value and believe this is the most likely outcome, though 70% suspect that it will be at least 2009 before an agreed solution is implemented. Indeed, 15% believe it will never happen.

This paper looks in more detail at analysts' views on current and future developments in financial reporting and their implications for the industry. In particular, it discusses whether a single basis of valuation is really possible in such a diverse business as insurance and therefore whether a 'multi-attribute' model may prove more viable. It also looks at why speeding up the search for a finalised IFRS could greatly improve insurers' ability to compete for capital with other industries.

Small step forward

IFRS may be an improvement on what went before, but it will not meet analysts' increasingly exacting expectations.

Many analysts have long been dissatisfied with the information provided by insurers. More than 60% of the analysts at the seminar hosted by PricewaterhouseCoopers in 2004 rated the adequacy of European insurers' financial reporting as 'poor'. Less than 10% felt that it was 'good'.

The advent of IFRS Phase I (IFRS 4) is therefore an opportunity for companies to raise the bar for the breadth and transparency of insurance disclosure. It is indeed encouraging that more than 80% of the analysts at the 2005 seminars believe that IFRS represents at least some improvement, albeit largely 'marginal' (see Figure 1).

Figure 1 | Views on IFRS

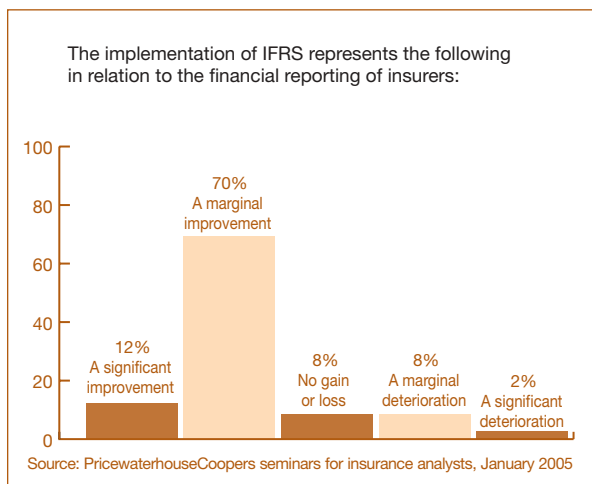
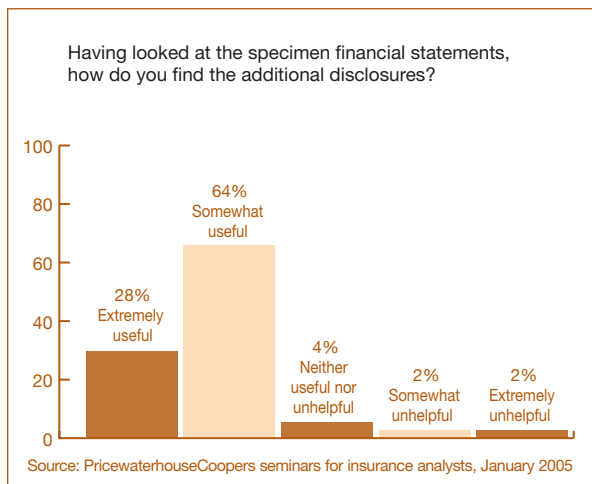
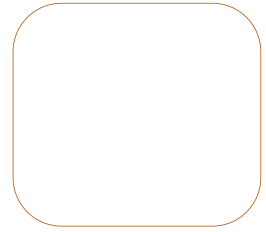
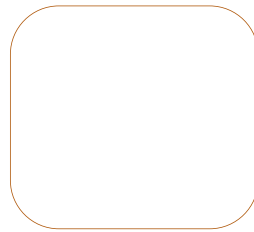
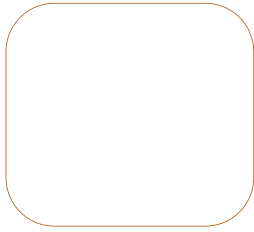


Figure 2 | Views on new disclosure





The enhanced disclosure framework was particularly welcomed by the analysts. Key features include more quantitative and qualitative information about claims development, risk management and sensitivity to market movements to help 'users understand the amount, timing and uncertainty of cash flows from insurance contracts'. When shown illustrative financial statements for a notional composite insurance group¹, 28% rated the additional disclosures as 'extremely useful' and 64% 'somewhat useful' (see Figure 2). This is more of an endorsement than for IFRS as a whole.

However, the enhanced disclosure framework also represents a challenge for insurers and the users of their accounts, as the IASB has left it largely up to companies themselves to decide how they present

this information. Until a common benchmark emerges, there could be considerable divergence in financial statements. This inconsistency could heighten the disparities between the various accounting principles in use across Europe and other parts of the world that have adopted IFRS, along with the continuing uncertainty over the future direction of IFRS for insurance contracts. Indeed, such doubts could attract a risk premium and raise the cost of capital.

Moreover, IFRS 4, which specifically deals with insurance contracts, including the definition of what is and is not insurance, is only one element of a far bigger picture comprising dozens of standards, all of which will affect insurers' financial statements in one way or another. Indeed, IFRS 19, which could force some companies to bring any

shortfalls in their pension provision into their equity, could in the short-term prove the most universally telling of all the changes. For life insurers, there is the need to account for many of their savings and pension plans as investment contracts under IAS 39. It is therefore significant that more than 80% of the analysts would prefer companies to adopt IAS 39 in full, rather than the 'carved out' version set out by the EU.

¹ To order copies of 'IFRS: Illustrative Consolidated Financial Statements 2004 – Insurance' please visit www.pwc.com/ifrs

Practice makes perfect

Most analysts welcome EEV in principle, but want to wait until it is applied in practice before they make up their mind.

European Embedded Value was launched last year by the European Insurance CFO Forum to help meet financial market demands for greater clarity and consistency in insurance disclosure, calls for which have grown in the wake of the uncertainty created by the move to IFRS. In particular, EEV will make it easier for analysts and investors to compare embedded values between different companies by setting out a single framework for calculation that must be applied by all users. EEV also seeks to take all risks into account, including options and guarantees.

More than two-thirds of the analysts at the January seminars believe that EEV is at least some improvement on what went before (see Figure 3). Nearly 80% feel EEV is more useful than IFRS Phase I (see Figure 4). Moreover, almost all (46% 'strongly agree' and 53% 'agree') believe EEV will improve the comparability of European life company accounts.

Figure 3 | Better than before?

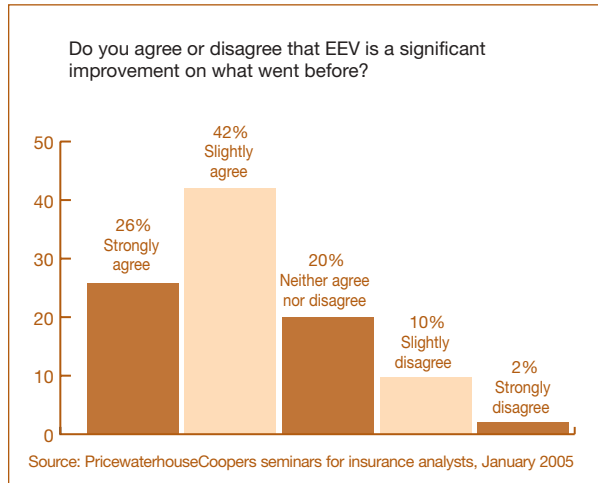
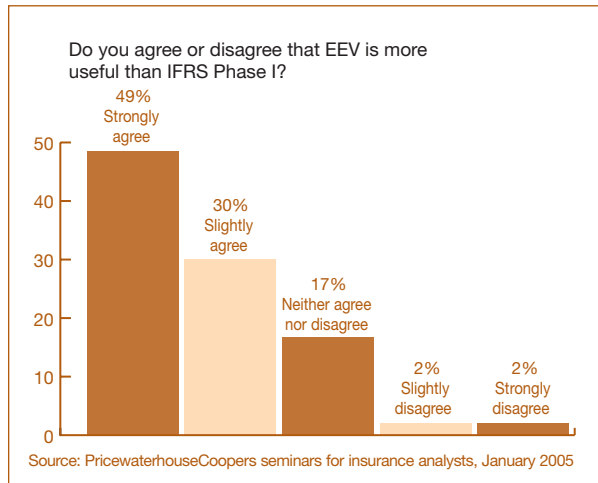


Figure 4 | Better than IFRS Phase I?



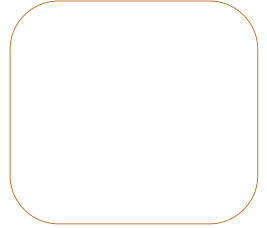
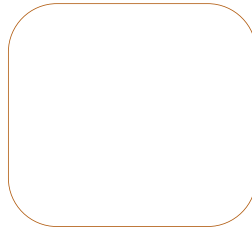
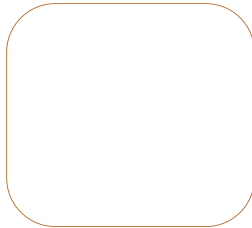
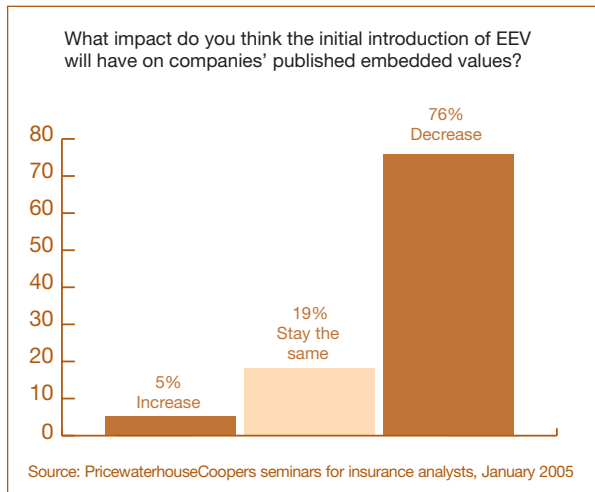


Figure 5 | Impact on the numbers?



However, the discussions revealed some reservations about how EEV, and in particular the risk margins, will be applied in practice. Underlying this was a certain amount of scepticism, which also emerged in relation to IFRS, about how as one analyst put it, 'companies always seem to arrive at the same number whatever the basis for evaluation.' It is perhaps significant that nearly 20% of the analysts believe that insurers' embedded values will stay the same, despite the modifications of EEV (see Figure 5).

While EEV is subject to external review, the ultimate test of credibility will come once the numbers are disclosed for real. At the time of writing, however, companies are only just beginning to publish their EEV evaluations.

Reflecting economic reality

Could a multi-attribute measurement model be the best way to account for a multifaceted business like insurance?

IFRS Phase I is only meant to be an interim solution. The seminars revealed broad analyst support for a finalised standard based on fair value principles (see Figure 6), though continuing reservations about the practicalities were evident. Most also feel that a move to fair value is the likeliest outcome (see Figure 7).

The high proportion of 'don't know' responses is perhaps a reflection of the difficulties of reaching a consensus on this issue. The IASB has set up a new Insurance Working Group to assist in the development of a framework for Phase II. The Group includes representatives from the industry and the project is being run in partnership with the US Financial Accounting Standards Board (FASB). Tellingly, the IASB recently told the Group that no standard is likely before 2008. Most of the analysts believe it could take even longer (see Figure 8).

Figure 6 | IFRS Phase II: Support for fair value

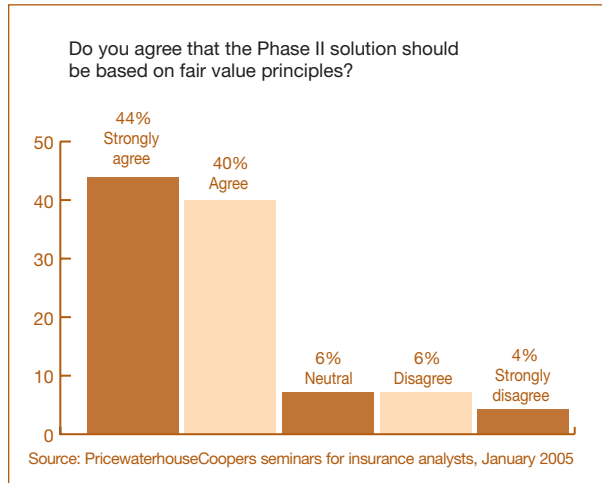
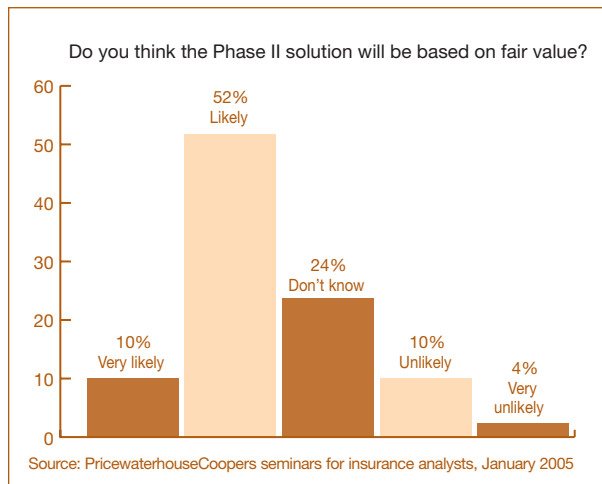


Figure 7 | IFRS Phase II: The likely outcome



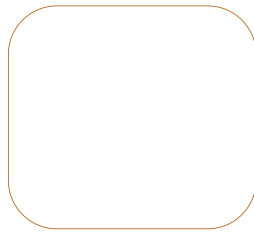
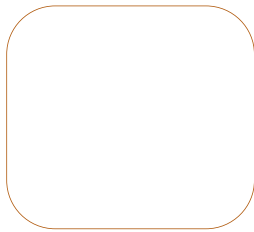
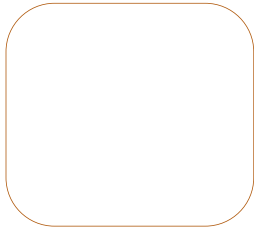
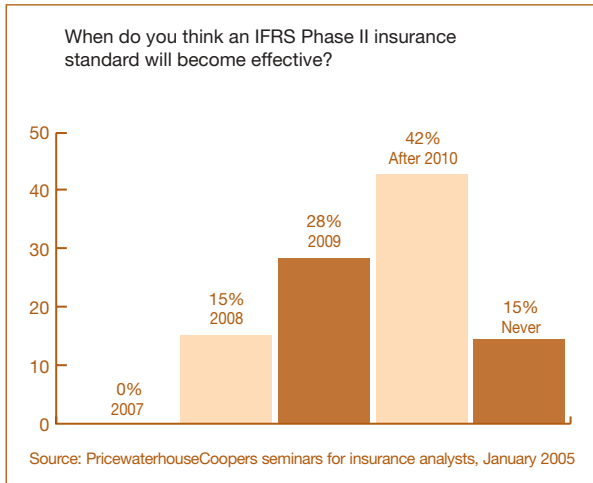


Figure 8 | Expected timing of Phase II



One consequence of any further delay in Phase II could be a change in the timetable for the interdependent EU Solvency II. The current proposals for the risk/capital management directive appear to have been based on a working assumption that a fair value IFRS would be in place ahead of implementation, possibly as soon as 2007. More pressing for insurers will be the need to resolve the uncertainty over IFRS as quickly as possible or risk losing out to other sectors in the competition for capital.

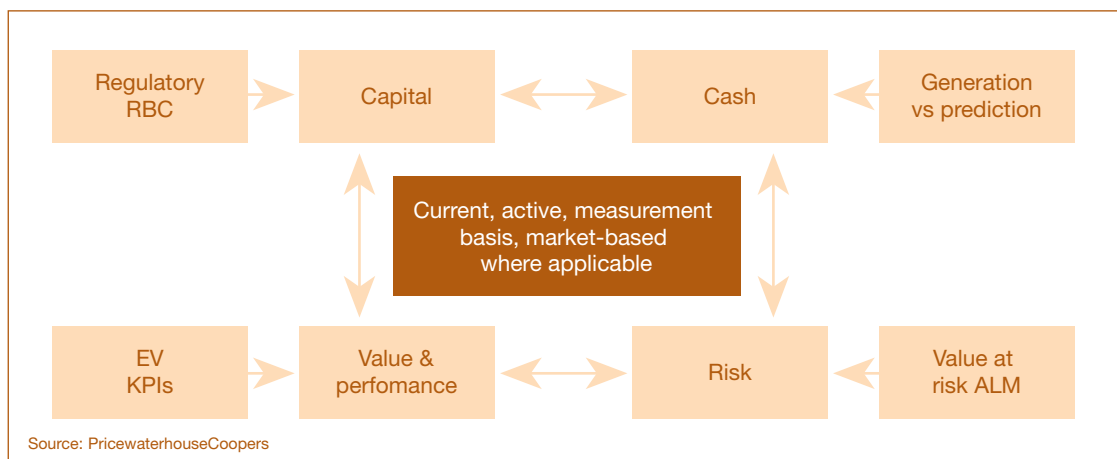
What are the options?

Fair value is of course one, though the IASB has so far failed to win over doubters within the industry. US GAAP is another and could help to gain the support of American insurers. However, US GAAP was designed to account for local products and there are practical problems in applying it in the European market. Indeed, is a single basis of measurement actually possible within such a varied industry as insurance? If there was one, would it not have been found by now?

The answer may lie in a broader 'multi-attribute' model based on a range of metrics that look at different aspects of the financial strength and performance of the business, as outlined in Figure 9. A primary income statement could be augmented by supplementary data geared to specific stakeholders such as risk-based capital for the regulators and EEV to help identify earnings potential for analysts and investors. A 'balanced scorecard' could be used to provide a framework for the necessary qualitative information.

Reaching agreement on this kind of flexible approach may have more chance of success than many would envisage. Although the IASB appears conceptually wedded to a pure fair value model, in practice it has been prepared to back away where necessary, most notably over the recognition of profit from day one. It is perhaps equally significant that there was such a wide spread of opinions over the analysts' preferred basis of accounting (see Figure 10). In short, there may well be more than one way forward for insurance accounting.

Figure 9 | Multi-attribute model for insurance reporting





Conclusion: The way forward

The next stage of the IFRS project is an opportunity for insurers to help develop an accounting model that genuinely reflects their performance and value potential.

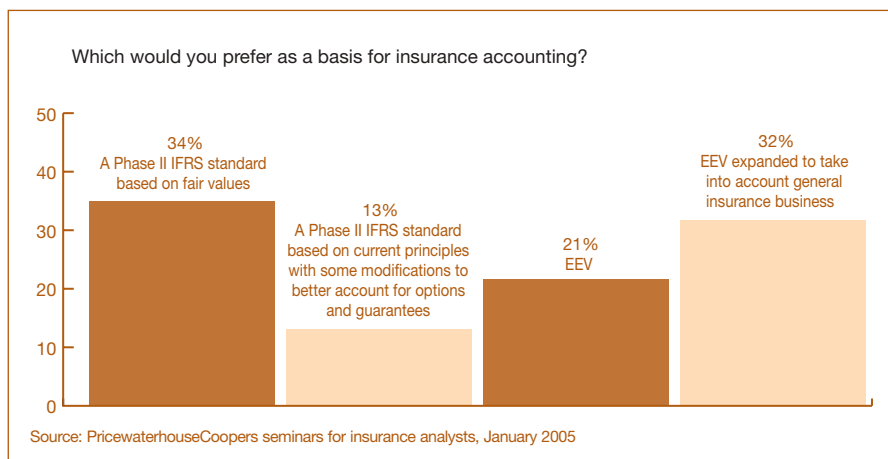
IFRS was meant to bring greater transparency and comparability to insurance reporting. However, the immediate impact could be heightened uncertainty and inconsistency and most analysts remain dissatisfied with the quality and clarity of the information they receive.

This can only harm insurers when they are facing an increasingly fierce battle for capital with companies from other industries and other countries.

It is therefore a strategic imperative for insurers and the IASB to achieve a credible Phase II solution as quickly as possible. Clearly, this will require an acceptance of the diverse nature of insurance business and the economic realities of how it is managed. The eventual Phase II will also need to reflect the views of analysts and investors as key users of accounts.

Analysts have in the past criticised the insurance industry for a lack of transparency and not adopting a common approach to financial reporting. The development of EEV by members of the industry is therefore a major step forward. Indeed, it is significant that a majority of the analysts attending the seminars in 2005 signalled that they are beginning to favour EEV over fair value (see Figure 10). Could analysts' growing support for EEV influence the shape of the eventual Phase II?

Figure 10 | Preferred basis for accounting



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