

# Financial Services

## Captive Accounting & Auditing Update — CANADIAN GAAP

Bermuda



### **CICA Section 3862, Financial instruments – disclosures CICA Section 1535, Capital disclosures**

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Alert Number: 08-02

#### **Extensive new disclosure requirements for financial instruments and capital applicable to all captive insurance companies reporting under Canadian GAAP**

CICA Section 3862, *Financial instruments – disclosures* (“CICA 3862”), and CICA Section 1535, *Capital disclosures* (“CICA 1535”), are the latest developments which have potentially significant ramifications for captive insurance companies reporting under Canadian GAAP.

In this update, we provide an overview of the new financial instruments and capital disclosures standards, together with detailed illustrative examples.

#### **Effective date**

- CICA 3862 and 1535 standards apply to interim and annual financial statements relating to fiscal years beginning on or after October 1, 2007.
- CICA 3862 and 1535 standards apply to all entities, including private companies and other non-publicly accountable enterprises and not-for-profit organisations.

#### **Purpose**

- The principles in CICA 3862 complement the principles for recognising, measuring and presenting financial assets and financial liabilities in Section 3855, *Financial instruments — recognition and measurement*, Section 3863, *Financial instruments — presentation*, and Section 3865, *Hedges*.
- The objective of the new requirements is to harmonise disclosure requirements for financial instruments and capital with IFRS 7, *Financial Instruments: Disclosures*, and IAS 1, *Presentation of Financial Statements*.<sup>1</sup>

#### **Key financial instrument and related risk disclosure requirements**

Outlined below are some of the more significant disclosure changes as compared to the existing standards that Captives will need to prepare for. Readers are encouraged to read the full text of the CICA 3862 and CICA 1535 standards.

#### **Qualitative risk disclosures**

- For each type of risk (credit risk, liquidity risk and market risk) a qualitative narrative is required. In conjunction with the required quantitative disclosures (see below), this is perhaps one of the most significant disclosures introduced by CICA 3862.
- Disclosure requirements include:
  - Identify the risk exposures of financial instruments and how they arise;
  - Identify the objectives, policies and processes for managing the risks and methods used to measure risk; and
  - Describe any changes from the previous reporting period.

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<sup>1</sup> PwC Captive Accounting & Auditing Update – IFRS 7, *Financial Instruments: Disclosures* (October 19, 2007)

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#### **Quantitative risk disclosures**

- For each type of risk, entities must disclose summary quantitative data on risk exposure at reporting date, based on information provided internally to key management personnel and any concentrations of risk.

Entities must also ensure they disclose the following information related to credit risk, liquidity risk and market risk:

- **Credit risk**
  - An entity's maximum exposure to credit risk and any related collateral held;
  - Information on the credit quality of assets that are neither past due nor impaired;
  - Analysis of the age of financial assets that are past due but not impaired; and
  - Analysis of financial assets that are individually determined to be impaired.
- **Liquidity risk**
  - A maturity analysis for financial liabilities showing the remaining contractual maturities and a description of the approach to managing the inherent liquidity risk.
- **Market risk**
  - A sensitivity analysis for each type of market risk (currency, interest rate and other price risk) to which an entity is exposed at reporting date. This should illustrate how profit or loss and equity would have been affected by "reasonably possible" changes in the relevant risk variable, as well as the methods and assumptions used in preparing such an analysis; and
  - Any changes in methods and assumptions from the previous period and reasons for such a change.

#### **Capital management strategy**

- CICA 1535 relates to capital management disclosures that companies may opt to combine with their risk management information for CICA 3862 disclosure purposes.
- The main requirements are to disclose quantitative and qualitative information about the entity's objectives, policies and processes for managing capital.
- A statement of compliance with external regulatory requirements is required.
- Best practice will be to present a clear and well defined picture of how the strategy enhances shareholder value, while meeting regulators' expectations.

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#### Illustrative disclosures

##### i. Market risk

Market risk is the risk the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: interest rate risk, foreign exchange risk, and other price risk.

##### Interest rate risk

Interest rate risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate due to changes in market interest rates.

The Captive funds its insurance liabilities with a portfolio of available-for-sale debt securities which is exposed to interest rate risk. Short-term insurance liabilities are not directly sensitive to the level of market interest rates as they are undiscounted and contractually non-interest bearing. The Captive manages interest rate risk by matching the cash flows profile of assets and liabilities.

##### Foreign exchange risk

Foreign exchange risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates.

The Captive is exposed to foreign currency risk as some of the Captive's transactions, assets and liabilities are denominated in Euros. Management has determined that there is minimal risk of significant losses due to exchange rate fluctuations and consequently the Captive does not hedge its foreign currency exposure.

##### Other price risk

Other price risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices, other than those arising from interest rate risk or currency risk.

The Captive is exposed to equity securities price risk because of its available-for-sale investments. To manage its price risk arising from investments in equity securities, the Captive diversifies its portfolio. Diversification of the portfolio must be done in accordance with the limits set by the group. The Captive's equity investments are publicly traded and are included in S&P 500 equity index.

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### CICA Section 3862, Financial instruments – disclosures CICA Section 1535, Capital disclosures

#### Illustrative disclosures

##### Market risk sensitivity analysis – suggested presentation option 1

#### ii. Market risk sensitivity analysis

##### Interest rate risk

An increase of 100 basis points in interest yields would result in a loss for the year of US \$ X (2007 – US \$ - Y). Of the total loss, US \$ X would have been recognised in equity (2007 – US \$ - Y).

A decrease of 100 basis points in interest yields would result in a gain for the year of US \$ X (2007 – US \$ Y). Of the total gain, US \$ X would have been recognised in equity (2007 – US \$ Y).

##### Foreign exchange risk

At 31 December 2008, if the Euro had weakened/strengthened by X% against the US dollar with all other variables held constant, post-tax profit for the year would have been US \$ X (2007: US \$ Y) higher/lower, mainly as a result of foreign exchange gains/losses on translation of Euro-denominated premium receivables.

Equity would have been US \$ X (2007: US \$ Y) lower/higher, arising mainly from foreign exchange losses/gains on translation of Euro-denominated equity securities classified as available-for-sale. Equity is more sensitive to movement in Euro/US dollar exchange rate in 2008 than 2007 because of the increased amount of Euro denominated equity securities classified as available-for-sale.

##### Other price risk

The table below summarises the impact of increases/decreases of the S&P 500 index on the Captive's post-tax profit for the year and on equity. The analysis is based on the assumption that the equity index had increased/decreased by X % with all other variables held constant and all the Captive's equity instruments moved according to the historical correlation with the index:

	Impact on post tax profit		Impact on equity	
	+X%	-X%	+X%	-X%
S&P 500 index percentage change				
	\$'000's	\$'000's	\$'000's	\$'000's
Held for trading (HFT) equities	2,000	(1,200)	2,000	(1,200)
Available for sale (AFS) equities	-	-	2,900	(1,500)

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*Market risk sensitivity analysis – suggested presentation option 2*

	Carrying amount Dec 31, 2008 (\$'000)	Interest Rate Risk				Foreign Exchange Rate Risk				Other Price Risk			
		-1%		+1%		-10%		+10%		-10%		+10%	
		Income (\$'000)	Equity (\$'000)	Income (\$'000)	Equity (\$'000)	Income (\$'000)	Equity (\$'000)	Income (\$'000)	Equity (\$'000)	Income (\$'000)	Equity (\$'000)	Income (\$'000)	Equity (\$'000)
<b>Financial assets:</b>													
Cash and cash equivalents	4,135	(41)	(41)	41	41	-	-	-	-	-	-	-	-
Premium receivable	610	-	-	-	-	17	17	(14)	(14)	-	-	-	-
HFT investments	1,300	-	-	-	-	32	32	(26)	(26)	(130)	(130)	130	130
AFS investments	1,800	-	100	(100)	-	-	-	-	-	-	-	-	-
<b>Total increase (decrease)</b>		(41)	59	(59)	41	49	49	(40)	(40)	(130)	(130)	130	130

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#### Illustrative disclosures

##### iii. Credit risk

Credit risk is the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.

Credit risk arises from the Captive's debt securities investments as well as credit exposures to reinsurers. For debt securities and reinsurers, only independently rated parties with a minimum rating of 'A' are accepted. The credit quality of financial assets that are neither past due nor impaired can be assessed by reference to external credit ratings.

The table below shows the credit rating and balance of the major counterparties (to financial assets that are neither past due nor impaired) at the balance sheet date:

	2008	2007
	\$'000's	\$'000's
<b>Debt securities:</b>		
Issuers' credit rating: AAA etc.	100,000	100,000
<b>Reinsurance recoverable:</b>		
Reinsurers credit rating: A etc.	25,000	25,000
Reinsurers credit rating: AA etc.	15,000	-
<b>Total assets bearing credit risk</b>	<b>140,000</b>	<b>125,000</b>

The table below shows an analysis of the age of premium receivables, at the balance sheet date, that are past due but not impaired:

	2008	2007
	\$'000's	\$'000's
Less than one year	1,000	500
More than one year	500	200
	<b>1,500</b>	<b>700</b>

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##### iv. Liquidity risk

Liquidity risk is the risk that the Captive will encounter difficulty in obtaining funds to meet its commitments. Prudent liquidity risk management implies maintaining sufficient cash and marketable securities, the availability of funding through an adequate amount of committed credit facilities and the ability to close out market positions.

The Captive's marketable investments have a maturity profile that ensures that it is able to meet liabilities arising from claims received.

The table below analyses the Captive's financial liabilities which will be settled on a net basis into relevant maturity groupings based on the remaining period to the contractual maturity at the balance sheet date. The amounts disclosed in the table are the contractual undiscounted cash flows. Balances due within 12 months equal their carrying balances as the impact of discounting is not significant.

	Expected cash flows (undiscounted)				
	Carrying amount Dec 31, 2008 \$'000's	Less than 1 year	1 - 2 years	2 - 5 years	More than 5 years
Provision for claims	80,000	10,000	20,000	30,000	20,000
Reinsurance balance payable	2,000	2,000	-	-	-
	82,000	12,000	20,000	30,000	20,000

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#### Illustrative disclosures

##### v. Capital management

The Captive's capital is comprised of fully paid up share capital, contributed surplus and retained earnings. The Captive's objectives when managing capital are to comply with the minimum capital and surplus requirements of The Insurance Act 1978 ("the Act") and to safeguard the Captive's ability to continue as a going concern so that it can continue to provide returns to its shareholders.

Under the Act, the Captive is required to meet certain minimum capital and surplus requirements. To satisfy these requirements, the Captive was required to maintain a minimum level of statutory capital and surplus of \$ X million at December 31, 2008 (2007- \$ Y million). The Captive's statutory capital and surplus was \$ X million at December 31, 2008 (2007 - \$ Y million), of which \$ X million is fully paid up share capital and, accordingly, there is no restriction on the payment of dividends to the shareholders from retained earnings.

Capital management note shall disclose any other fixed capital, as defined by the Act, such as irrevocable letters of credit approved by the BMA for utilisation as part of the Captive's statutory capital.

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