

# Putting IFRS in motion\*

The impact of International Financial Reporting Standards (IFRS) on the Canadian insurance sector



# Introduction

More than 100 countries have adopted the use of International Financial Reporting Standards (IFRS) by public companies. The Canadian Accounting Standards Board will require publicly accountable enterprises to adopt IFRS as Canadian generally accepted accounting principles (GAAP) for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. The move to IFRS will fundamentally change the way Canadian insurers report their business results to analysts, investors and other stakeholders.



Implementing IFRS may be perceived within your organization to be an accounting exercise but the reality is it will be a far more complex process that goes well beyond the finance and accounting functions. Other business operations such as the human resources, investor relations, actuarial, business development and information technology (IT) departments will likely be involved in the IFRS conversion plan.

Our experience in assisting numerous global insurers that have already adopted IFRS shows that for some, full conversion and adoption can take anywhere from two to five years, depending on the type of insurance products, the extent of system standardization and the geographical distribution of the organization.

The insurance industry in Canada is expected to be significantly impacted by the move to IFRS, but exactly how is still unclear. The complexity of accounting for insurance contracts resulted in the International Accounting Standards Board (IASB) taking a two-phase approach. The first step was the issuance of IFRS 4, “Insurance Contracts” (also referred to as Phase I), which was limited in scope but provided insurers for the first time with a universal definition of an insurance contract. It did not address the measurement and recognition of insurance contracts and left the valuation methodology currently followed (under local GAAPs) in place. Phase II is still under development and will address the valuation of insurance contracts. It is not expected to be effective until 2012, or later.

For some insurers, how they account for their insurance contracts may not be significantly impacted by the adoption of IFRS as it stands for 2011. However, for others that have products that don’t meet the definition of an insurance contract, it could mean a significant change in the amount of revenue recorded in the income statement. One of the most significant challenges in converting from Canadian GAAP to IFRS is understanding the differences between Canadian GAAP and IFRS and how those differences will impact the organization.

This publication provides:

- An overview of the Accounting Standards Board’s (AcSB) timeline for the adoption of IFRS;
- An outline of some of the significant accounting differences between Canadian GAAP and IFRS in the insurance sector (including some of the more contentious issues of the proposed components of IFRS 4 Phase II, valuation and measurement of insurance contracts); and
- Insights into the considerations for the adoption of IFRS.

The background and context behind the decision to adopt IFRS and the key strategic issues you will face in converting to IFRS are outlined in our publication, *Putting IFRS in motion – Are you on track?* To obtain a copy, contact a PricewaterhouseCoopers professional or visit [www.pwcifrs.ca](http://www.pwcifrs.ca).

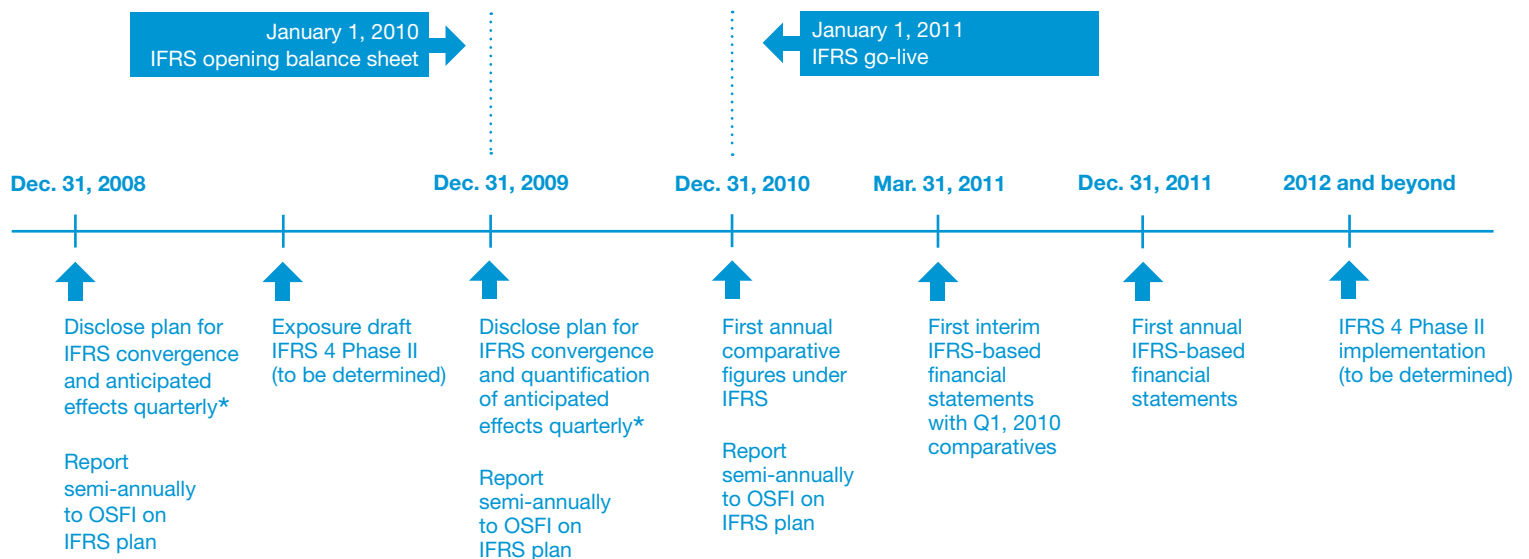
Companies that have already implemented IFRS understand that the adoption of IFRS may place a sizeable responsibility on management to be able to communicate effectively to the market in the new IFRS language.

# Accounting under IFRS

Canadian publicly accountable enterprises must use IFRS to prepare interim and annual financial statements for fiscal years beginning on or after January 1, 2011. However, the standard on the valuation of insurance contracts is not expected until 2012 or later, after insurers have already adopted IFRS. As a result, insurers will have the complication of a two-stage adoption process. This will have to be taken into account when developing project plans. Companies will also have to take into consideration upcoming changes in capital management and regulatory requirements resulting from the developments of Solvency II. We believe that the timing of both IFRS 4 Phase II and Solvency II will put additional strain on actuarial resources and increase the need for modelling expertise.

In May 2007, the IASB published a discussion paper setting out draft proposals for the measurement of insurance contracts (IFRS 4, Phase II). This standard redefines how insurance liabilities will be valued and it attempts to provide a more economically relevant valuation that will allow for consistency and comparability across borders. Despite the uncertainty around the valuation model that will be adopted and the extended time horizon to implementation, companies cannot afford to ignore the proposals. The direction that the IASB would like to follow is clear and the implications to the industry could be significant. Organizations need to understand the proposed standard for the valuation of the actuarial liabilities and assess the implications on their business. An overview of the key concepts in IFRS 4, Phase II is provided on page 6 of this publication.

## The Canadian IFRS conversion timeline: Key dates and milestones



Early adoption is expected to be permitted, but will not be allowed for statutory filings of federally regulated financial institutions (FRFI) by the Office of the Superintendent of Financial Institutions (OSFI).

\* Canadian Securities Administrators Staff Notice 52-230 requires quarterly disclosures in Management's Discussion and Analysis starting in 2008 on the expected impact of the adoption of IFRS.

## IFRS 4, Phase I – Insurance accounting

IFRS 4, although limited in scope, introduces new concepts previously not addressed in Canadian GAAP.

Key elements of the standard:

- The standard is applicable to all entities that issue an insurance contract whether or not the entity is regarded as an insurance company. The same standard will apply to both Life and P&C enterprises.
  - It includes a definition of an insurance contract; distinguishes insurance risk from financial risk; and does not set a numerical range in order to assess the existence of insurance risk. Contracts that do not meet this definition are recorded as investment or services contracts.
  - For insurance contracts containing both insurance and deposit components, unbundling of the contracts may be required or permitted.
  - It provides definition of discretionary participation features (contractual right to receive additional benefits in excess of guaranteed payments).
  - The offsetting of insurance liabilities against related reinsurance assets is disallowed. This is also applicable for income and expenses that are offset against reinsurance amounts.
  - IFRS 4 (until Phase II is completed) continues to allow insurers to apply local GAAP for the measurement of insurance liabilities. However, the insurance liability is subject to a liability adequacy test. If the liability is inadequate, the entire deficiency is required to be recognized in profit or loss.
- Shadow accounting is permitted. This is applicable to models where the carrying value of assets affect measurement of insurance liabilities; allows adjustments for insurance liabilities to follow unrealized gains and losses to equity.

### Insurance-specific disclosures

Additional disclosures are required. Some of these focus on:

- Accounting policies adopted;
- Material amounts reported;
- Process to determine assumptions that affect the measurement of amounts recognized, and quantification of those assumptions;
- Effects of changes in assumptions used, showing separately the effect of each change on amounts recognized;
- Claims development tables; and
- Sensitivity and concentration of insurance risk.

## First-time adoption of IFRS

Under IFRS 1, the underlying principle on adoption of IFRS is retrospective application of all IFRS standards (with certain mandatory and optional exemptions) in effect at the entity's reporting date. Where differences exist and there is no exemption available, companies may have to put in significant effort to remeasure various historical transactions under IFRS. Early identification of Canadian GAAP differences and consideration of the exemptions are very important for a successful conversion.

# Canadian GAAP/IFRS differences

Despite the lack of an insurance standard on how to value insurance contracts there are still a number of Canadian GAAP/IFRS differences that must be considered. We have summarized some of the differences that are most relevant to the insurance industry. This list is not meant to be all-inclusive and we urge you to refer to the full set of IFRS standards when assessing the differences for your organization.

## Accounting framework

### First-time adoption of accounting framework

- Full retrospective application of all IFRS effective at the reporting date, with some optional exemptions and limited mandatory exceptions
- Reconciliations of profit or loss, equity and cash flows reported under previous GAAP

### Historical cost

- Generally uses historical cost, with a growing emphasis on fair value
- Unlike Canadian GAAP intangible assets, property, plant and equipment and investment property may be revalued to fair value

## Consolidation and business combinations

### Consolidation model

- Control model but variances from Canadian GAAP in the definition of control
- Implications of IFRS on Canadian regulatory requirements (e.g. financial statements currently filed on a non-consolidated basis) are yet to be determined

### Special purpose entities

- An entity consolidates an SPE when the substance of the relationship between the entity and the SPE is controlled by the entity – control may arise at the outset through the predetermination of the activities of the SPE or otherwise
- An entity may be deemed to control an SPE if it is exposed to the majority of risks and rewards incidental to its activities or its assets
- The population of SPEs as defined under IFRS will not necessarily be the same as the population of variable interest entities as defined under Canadian GAAP

### Cost of acquisition

- Fair value of shares issued as consideration is measured at the transaction exchange date rather than over a reasonable period before and after the date the terms are agreed to and amended
- Liabilities for restructuring activities are recognized only when acquiree has an existing liability at the acquisition date

### Contingent consideration (revised IFRS 3)

- Contingent consideration recognized at fair value, even if it is not deemed to be probable of payment at the date of the acquisition

### Goodwill

- One-step approach to impairment testing
- Impairment testing performed at a different level (cash-generating units or group thereof)

### Minority interest (revised IFRS 3)

- Revised standard gives entities the option, on a transaction-by-transaction basis to measure non-controlling interests at the fair value of their proportion of identifiable assets and liabilities or at full value
- Full value approach will result in goodwill on the non-controlling as well as on the acquired controlling interest

# Assets

## Investment properties

- Measured at depreciated cost or fair value, with changes in fair value recognized in the income statement
- If cost model is used there is still a requirement to disclose fair value
- Moving average market method used by the Life Insurance industry does not exist under IFRS

## Property, plant and equipment

- Historical cost or revalued amounts are used – regular valuations of entire classes of assets are required when the revaluation option is chosen
- One-step impairment test under IFRS, using discounted cash flows may lead to more frequent recognition of impairments
- Amount of write-down may also differ as IFRS requires an impaired asset to be written down to the higher of its fair value less selling costs or its value in use

## Financial instruments

- IAS 39 contains additional restrictions on financial assets and financial liabilities optionally designated as fair value options through profit or loss (similar to OSFI Guideline D10)
- Available-for-sale (AFS) stocks without a quoted price in an active market and whose fair value cannot be reliably measured are recorded at cost (expected to be rare)
- Foreign exchange gains and losses arising on AFS assets are recognized through profit or loss
- No option to expense transaction costs on AFS securities

## Deferred acquisition costs (DAC)

- Under IFRS 4, entities are permitted to record DAC – IASB's Phase II discussion paper proposes to eliminate the deferral of such costs

## Intangible assets

- Permits revaluation to fair value for assets having an active market
- Differences in impairment testing consistent with property, plant and equipment previously described

## Segregated funds

- Concept does not exist in IFRS and the single line presentation is not permitted
- Assets are accounted for by similar nature or function

# Liabilities

## Unearned premiums (UPR)

- Under IFRS 4, entities are permitted to record UPR – IASB's Phase II discussion paper proposes to eliminate the UPR concept

## Leases

- No quantitative benchmark to assess lease classification

## Employee future benefits

- Permits a choice of accounting policy to recognize actuarial gains and losses directly in equity rather than as part of income
- Differences in measurement date – IFRS requires a valuation be performed with sufficient regularity that the amounts recognized in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date
- Multi-employer plans with defined benefit characteristics are accounted for as defined benefit plans (if sufficient information is available)

## Stock-based compensation

- Cash settled awards are measured at fair value



## IFRS 4, Phase II – The future of insurance accounting

The IASB's project on insurance contracts has been a focus of attention and discussion for several years. The release of the discussion paper in May 2007 elicited a high level of response. Now, a few months after the closure of the comment period, we can provide a summary of the responses to get a better understanding of what the future holds in the area of insurance accounting.

- The three building block approach (best estimate of future cash flows, discounted to reflect the time value of money with margins for bearing risk and providing other services) is considered a useful framework but “virtually all” respondents had “significant” concerns about important aspects of the building blocks.
- These concerns with the three building blocks include:
  - issues around the recognition of, and the amount of, profit at inception;
  - need for clarity around the nature of, and basis of calculation of, risk margins;
  - rationale for the service margin;
  - use of estimates of expenses that market participants would incur rather than entity-specific expenses;

- use of discounting and risk margins for non-life insurance contracts;
  - reflection of a liability’s credit characteristics in its carrying value;
  - use of a discount rate reflecting the characteristics of the liability rather than an asset-based rate; and
  - artificial constraints on cash flows, resulting from future premiums and expected payments to participating policyholders.
- The suggested measurement attribute, “current exit value,” based around a transfer concept, was supported by some respondents but many suggested further consideration of a settlement basis was needed, reflecting the anticipated means of “exit” from the obligation for insurers.
  - Many respondents suggested that measurement should focus on the contract as a whole rather than on those individual rights and obligations underlying a contract that meet the definitions of assets and liabilities.
  - Many respondents opposed the guaranteed insurability test for future cash inflows (notably future premiums).
  - Concerns were expressed that the current International Accounting Standard (IAS 37) liabilities project may narrow the definition of a constructive obligation and, therefore, limit the ability to recognize all expected cash flows associated with payments to participating contract policyholders.
- In relation to performance reporting, most respondents viewed all premiums as revenue, especially, for non-life contracts, although some saw merit in a margin approach, notably for life contracts.
  - Views were mixed on allowing for diversification benefits beyond the portfolio level.
  - Respondents generally agreed that acquisition costs should be expensed when incurred but noted that this was on the proviso that the measurement model allows all future cash flows from which acquisition costs would be expected to be recovered.
  - Many respondents did not agree with the unbundling proposals in the discussion paper.
  - Various concerns were expressed around the timetable and process, with particular reference to the interaction with other ongoing IASB projects, particularly, revenue recognition, the implications of the FASB joining the project and the need for field testing to be carried out.

There were 161 respondents from all parts of the world, including Canada, United States, Australasia and Europe, indicating that this is truly a global debate. The IASB had hoped to issue an exposure draft in late 2009; however, with the list of issues to address, we may have to wait a little bit longer to truly understand the extent of the impact of IFRS on the insurance industry.

# Conversion is not just a technical accounting exercise

IFRS will present unique challenges for senior management, the financial reporting function, the actuarial function and many other areas across the organization. IFRS may impact existing management reporting, including budgets, forecasts, performance measures, reward schemes and bonus structures, key performance indicators (KPIs) and covenants. Furthermore, new procedures should be considered to ensure IFRS implications are considered as part of the approval process for all new strategic investments. Depending on the size and complexity of the organization, most insurance companies will likely find that their actuarial, tax, human resources, IT, investor relations and business development departments will need to be involved in planning this transition to IFRS.

IFRS across the organization		
<p><b>Implementation Resources</b></p> <ul style="list-style-type: none"> <li>• Need for resources over 12-18 months</li> <li>• Competing projects</li> <li>• Not just a finance issue</li> </ul> <p><b>Training and Education</b></p> <ul style="list-style-type: none"> <li>• All finance staff will need some training</li> <li>• Broader awareness of the issues</li> <li>• Other business professionals within organization</li> <li>• Executives need to be able to understand and explain the “new” numbers</li> </ul>	<p><b>Acquisitions</b></p> <ul style="list-style-type: none"> <li>• Need for IFRS figures for due diligence</li> <li>• Models required for annual goodwill impairment tests</li> </ul> <p><b>Financing/Refinancing</b></p> <ul style="list-style-type: none"> <li>• Impact of IFRS on earnings or asset-based debt covenants</li> </ul> <p><b>Remuneration</b></p> <ul style="list-style-type: none"> <li>• Impact of earnings volatility on profit-based bonus plans</li> </ul>	<p><b>Systems and Processes</b></p> <ul style="list-style-type: none"> <li>• Need for different/new data</li> <li>• New systems</li> </ul> <p><b>SOX/ICOFR Certification</b></p> <ul style="list-style-type: none"> <li>• Process/control documentation updates</li> </ul> <p><b>Investor Relations</b></p> <ul style="list-style-type: none"> <li>• Preparing analysis for the impact of IFRS</li> </ul> <p><b>Management Reporting</b></p> <ul style="list-style-type: none"> <li>• Budgets, forecasts, management accounts and KPIs need to be on an IFRS basis</li> </ul>

## Communication

The financial statements of a Canadian insurance company will look different under IFRS than they currently do under Canadian GAAP. Senior executives need to be prepared to discuss the reasons for, and the nature of, the differences with board members, shareholders, the investment community and financial analysts. A detailed communication plan is necessary to educate stakeholders and actively manage perceptions.

There are a number of areas within IFRS that are subject to interpretation. While a primary aim of the IASB is to have a global set of standards applied consistently, the reality is that there are differences in the specific application of a particular accounting rule from one company to another.

Communication of key policy choices, interpretations and accounting decisions in some detail may also be necessary to differentiate and explain an insurance company's financial results under IFRS as compared to its peers.

Our experience with companies in Europe has shown that early communication, including the sharing of pro forma financial statements with preliminary figures and/or opening balance sheets under IFRS in advance of transition date, has allowed investors and analysts to understand and get comfortable with financial results and their presentation. In contrast, late or absent dialogue with key stakeholders concerning the financial implications of the adoption of IFRS could result in a direct impact on share price.

## Impact on systems and processes

IFRS compliance may require the realignment of reporting systems for new and additional data.

Our experience has shown that many companies implementing IFRS underestimate the time and resources needed to meet this challenge. This is especially true with existing management systems or legacy systems from past acquisitions that have never been updated and are not geared to provide sufficient or appropriate data for preparing new and increased disclosures. This is significant for the insurance sector where additional disclosure requirements are substantial. To make the best decisions on IT investment and ensure users are engaged, it is important that company IT executives have sufficient time to perform systems realignment and are not forced to complete this work in a "fire-drill" environment.

Other process changes under the move to IFRS can be equally as important and may include:

- Revising existing reporting templates and other checklists to incorporate data required for disclosures under IFRS;
- Rationalizing or expanding the chart of accounts to post additional measurement changes and/or collect additional disclosures under IFRS;
- Reviewing period-end close procedures to achieve efficient close times; and
- Reviewing the capability of the actuarial processes for gathering IFRS-compliant information.

## Education, awareness and culture

The migration to IFRS may also require a training program that combines knowledge transfer with the ability to address skills, attitudes and motivation. The entire organization, not just finance and accounting, will need to be trained in this area (e.g. functions such as actuarial, underwriting, product development and investor relations). Training should focus on what information individual business units will need to provide in order to comply with IFRS and how IFRS will affect their decision-making and value creation strategies.

Early awareness training on the important impact areas and changes under IFRS will enable key stakeholders, such as key executives and board members, to be fully briefed on the new requirements and help drive a positive spirit of change management throughout the organization.

## Regulatory requirements

The adoption of IFRS will require Canadian entities to consider various regulatory requirements.

### OSFI and Canadian Securities Administrators (CSA) requirements

OSFI has confirmed in a letter to the industry that:

- All FRFIs are considered publicly accountable enterprises;
- No early adoption will be allowed for FRFIs; and
- All FRFIs must submit to OSFI a semi-annual progress review on their plan to adopt IFRS within 30 days of the end of the period.

OSFI has indicated that the semi-annual progress review should be modeled after the disclosure requirements issued by the CSA. The report should discuss the status of key elements and timing of the conversion plan, which might include the impact of IFRS on:

- Accounting policies, including choices among policies permitted under IFRS, and implementation decisions such as whether certain changes will be applied on a retrospective or prospective basis;
- Information technology and data systems;
- Internal control over financial reporting;
- Disclosure controls and procedures, including investor relations and external communications plans;
- Financial reporting expertise, including training requirements; and
- Business activities, such as foreign currency and hedging activities, as well as matters that may be influenced by GAAP measures such as debt covenants, capital requirements and compensation arrangements.

### Use of IFRS by Canadian SEC registrants

A significant benefit to a Canadian SEC registrant of adopting IFRS-IASB is that the entity will no longer have to reconcile its primary financial statements to US GAAP in SEC filings. The SEC also has extended an accommodation to first-time IFRS reporters, enabling them to present only a single year of comparative financial statements, rather than the two years it usually requires.

The SEC's IFRS accommodations are effective now but are not available to Canadian SEC registrants before 2011, unless an early adoption of IFRS as an option is approved for 2009 by the AcSB.

On adopting IFRS, a Canadian SEC registrant will no longer have to reconcile to US GAAP but might lose its option to prepare financial statements using US GAAP.

### Internal controls over financial reporting

Public companies will also need to consider Multilateral Instrument 52-109 (certification of disclosure in issuers' annual and interim filings) and Sarbanes-Oxley requirements (management assessment of internal controls) as they transition to IFRS. Specifically, entities will need to update their documentation on the internal controls over financial reporting and related evaluation procedures for processes and changes impacted by the IFRS migration.

## Merger and acquisition implications

The move to IFRS may add increased complexity to M&A transactions in countries that have not yet adopted IFRS.

The main challenges will be the need to translate the target's historical and projected performance into IFRS to assess the accounting implications of the transaction and to understand the impact on the acquirer's earnings per share. The potential cost of bringing the target's reporting systems up to the acquirer's standards and, the time required to do this, could significantly affect a company's ability to realize integration synergies, especially, as we get closer to the transition date.

To the extent that a Canadian entity completes any acquisition of a target company not currently reporting under IFRS, before 2011, they will need to include the target company in their IFRS conversion and readiness plan.

Our experience assisting companies with M&A transactions has shown that they have struggled to obtain the additional data and disclosure requirements of target companies under IFRS.

## Planning an effective conversion

It is easy to underestimate the volume and complexity of the work involved with the implementation of IFRS.

Our experience in Europe and Australia has shown that some companies transitioning to or applying IFRS for the first time will try to make manual adjustments from local GAAP to IFRS using spreadsheets or similar tools. These quick fix conversions are often not the most cost-effective choice in the long run—especially, as these fixes can be prone to error, confusion and typically lack the appropriate internal controls surrounding its preparation.

To ensure sustainable and uniform application of IFRS throughout your organization, you will need to document your accounting policy selections and make sure they are consistently followed.

**Each individual company will have unique circumstances that require sound judgment and expert advice. Advanced planning and an in-depth diagnostic of how IFRS will affect your company's financial reporting will reduce the risk associated with compliance and lower the overall cost of transition.**

# How we can help

PricewaterhouseCoopers has unparalleled experience in helping many of the world's largest companies adopt IFRS. Our dedicated resources and experience in working with many of the more than 12,000 companies that have already made the transition to IFRS have taught us valuable lessons that will help Canadian insurance companies with their own conversion process. We have assisted, and are assisting, a large number of insurance organizations with IFRS conversion projects globally and in Canada.

Our industry-focused teams specialize in GAAP/IFRS conversions for a wide range of organizations—from large, complex institutions, requiring detailed analysis, to organizations with more straightforward requirements. These teams are supported by our Capital Markets Group, a global team of over 500 IFRS conversion experts, who specialize in multi-GAAP environments and the related conversion implications.

**PricewaterhouseCoopers is the largest provider of professional services to the insurance industry. This has allowed us to develop unique insights into the challenges, issues and best practices that engage companies across the industry. PricewaterhouseCoopers provides services to 89% of insurance companies listed on the FT Global 500.**

**PwC professionals can help you plan and complete your transition to IFRS by providing:**

- **An initial diagnostic of Canadian GAAP/IFRS accounting differences**
- **Advice on selection of appropriate accounting policies**
- **Advice on development of an IFRS implementation plan**
- **Training for all levels of your staff, including your board of directors**
- **IFRS trained and experienced people to supplement your IFRS team**
- **Actuarial process review and modelling expertise**
- **Project management support to your IFRS team**
- **Communication strategies and change management support**
- **Assessment of your requirements for data, processes, systems and controls**
- **Advice on process and system solutions to embed IFRS**
- **Competitor benchmarking**
- **M&A target accounting conversion assistance**
- **Valuation advice under IFRS fair value and impairment models**
- **Tax planning considerations on conversion to IFRS**

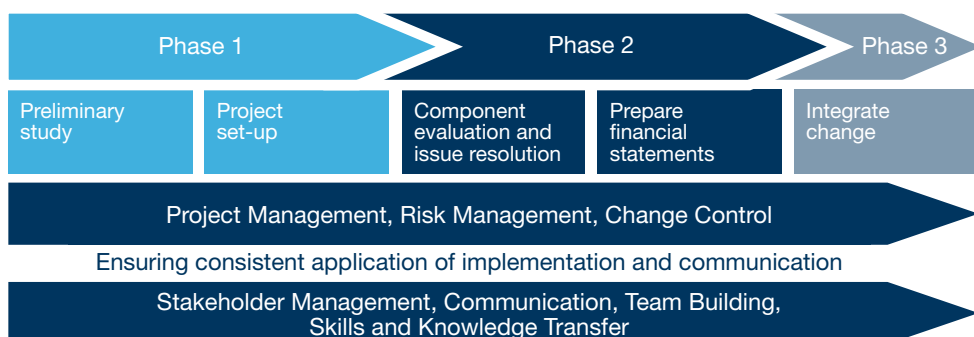
## PwC's Transition/IFRS Methodology

While compliance with new rules is the driver for IFRS projects, our experience indicates that a methodical approach to the conversion process can yield wider benefits. Our Transition/IFRS methodology is a robust, tried and tested framework that has an inherent flexibility, enabling us to adapt it to work most effectively within your organization and one that we would tailor to your needs and phases, as outlined below. This methodology has consistently delivered successful results.

Typically, each IFRS transition project consists of three phases. In Phase 1, the diagnostic stage, we carry out an initial impact analysis and plan the later phases. Phase 2 consists of the detailed steps necessary to prepare the first complete IFRS financial statements. In Phase 3, we take the information, issues and solutions gathered, and integrate them into your underlying financial systems and processes.

Transition/IFRS acts as a springboard from which you can launch and control your conversion project, accessing the support and guidance you need as the implementation progresses.

We are ready to help you manage the conversion process with fewer headaches. To learn more about how we can help, visit our website at [www.pwcifrs.ca](http://www.pwcifrs.ca) or contact one of the IFRS professionals listed.



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For more information  
on IFRS and to view  
IFRS publications,  
visit our website  
at [www.pwcifrs.ca](http://www.pwcifrs.ca).

This publication does not provide a complete list of Canadian GAAP differences that Canadian insurance companies need to consider on transition to IFRS.