Financial Services

# Get set for IFRS Insurance Phase II:

## The planned changes, the business implications and what you should consider doing now*

*connectedthinking

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# Overview

**In May 2007, the International Accounting Standards Board (IASB) published a discussion paper setting out draft proposals for a new International Financial Reporting Standard for insurance contracts (IFRS Phase II) that is due to come into force around 2012. The comment period runs until 16 November 2007.**

The IASB proposals are designed to provide a more economically relevant valuation of insurance contracts that draw on market assessments of the expected risks and rewards. The business implications include what could be a marked shift in the trajectory of reported earnings and the potential need for a fundamental change to systems, organisation and professional resource requirements of insurance companies.

These proposals are presented as ‘preliminary views’ and they will be reconsidered in the light of comments from all interested parties. However, the direction the IASB would like to follow is clear and companies cannot afford to ignore the proposals. EU insurers have an additional reason to take note, as the planned new solvency capital requirements (Solvency II) will be based on an approach that is similar to the IASB proposals.

## Financial reporting implications:

- **Potential earnings volatility:** The need to take account of movements in market variables could lead to volatility in the reported earnings as contracts would need to be re-valued at each reporting date, based on current estimates.
- **New basis of valuation:** The value of insurance contracts would be based on a forecast of future cash flows that draws on market inputs and is designed to equate to the amount that would change hands if the contract were to be transferred to a third party (‘current exit value’).
- **Potential day one profit and loss:** Accounting using current exit values could lead to a reported profit or loss at the inception of the contract.
- **Impact on revenue:** The discussion paper questions whether certain premiums should be treated as income or deposits. The latter choice could significantly affect the level of reported ‘top line’ revenue.
- **Impact on equity:** Policyholder bonuses would only be classed as liabilities if there is a legal or constructive obligation to pay them. If not, they would be included in the company’s equity, even though they may not be available for distribution to shareholders. This could increase certain companies’ reported equity.
- **US-IFRS convergence:** The US Financial Accounting Standard Board (FASB) is about to publish the IASB discussion paper to assess the possibility of converging US GAAP towards the IFRS Phase II model.

## Operational implications:

- **Systems impact:** The challenge for the IASB will be to make IFRS Phase II relevant. The challenges for insurers will be how to make IFRS Phase II reliable, with effective implementation plans and clear explanation to the markets. The need to forecast future cash flows at each reporting date based on current and probability-weighted evaluations of varying risk and reward scenarios could require a significant upgrade of modelling capabilities and the controls that surround them. Even if these systems are already in place, the outputs would need to be brought up to an auditable standard.
- **Organisational impact:** The use of risk margins and dynamic cash-flow analyses in accounting will require closer integration between finance, regulatory, actuarial, and risk and capital management teams. Insurers operating in more than one country also face the challenge of moving to a single basis of accounting for insurance contracts, applied consistently by all territories.
- **Resource impact:** Any extension of the demands on modelling, analysis and reporting could require more qualified actuarial personnel, as well as finance and IT personnel, that grasp the complex new requirements.
- **Parallel developments:** The proposed changes to the IFRS for insurance contracts form part of a series of overlapping developments in regulation (such as the EU Solvency II[1] project) and market communications (in particular market-consistent embedded value). Identifying and exploiting the systems and organisational synergies of these parallel projects could save costs and enhance operational efficiency.

**Figure 1 – Milestones**

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|---|---|
| 3 May 2007 | Publication of IASB discussion paper and beginning of consultations |
| 16 Nov 2007 | End of comment period |
| End of 2008 | IASB plans to publish exposure draft |
| 2010 | IASB plans to publish IFRS |
| 2012+ | First full set of financial statements under new IFRS |

**Source:** PricewaterhouseCoopers[2]

[1] For more information on Solvency II, please refer to the PwC publication, Gearing up for Solvency II: The New Business Environment, August 2007 Copies of the publication are available to download from www.pwc.com/solvencyII.

[2] PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

## What you should consider doing now

Developing a consensus on the planned IFRS Phase II will be difficult and much of the detail may change between now and implementation. When these changes will come into force is also uncertain. However, it would be reasonable to make a working assumption that change is coming and that the eventual IFRS Phase II is likely to make more use of a forecast of future cash flows that reflects movements in market variables than companies have been used to. Based on this assumption, it would be possible to begin laying some of the important groundwork for dealing with the developments ahead:

- **What does this mean for your business:** Assess how the proposals set out in the discussion paper could affect your reported numbers, along with the impact on systems and operations, including resource levels, required skill-sets and finance function organisation. Companies implementing Solvency II in the EU and/or market-consistent embedded value should actively assess the potential synergies presented by these developments and determine the ways in which such projects could be run in common; and
- **Make your views count:** Based on this appraisal, take the opportunity to comment on the discussion paper. While there will be further opportunities to comment following the publication of an exposure draft, the current consultations offer the best chance to influence the fundamental principles.

The remainder of this flyer looks in more detail at the business implications of the latest proposals for IFRS Phase II. There is also an appendix providing a brief technical outline of the proposals. If you would like more details and guidance on the technical and practical aspects of the discussion paper please speak to your usual PricewaterhouseCoopers[2] contact or one of the partners listed on the back page.

# Momentum for change – developing prudent working assumptions

IFRS 4 left the various local accounting principles largely in place. This fragmented reporting regime can make insurers' financial statements difficult to compare, both with other insurers and with companies from other sectors.

> 'There are some doubts about the transparency and relevancy of reported numbers and that puts us at a competitive disadvantage in that we have to pay higher costs of capital.'
>
> Dr Helmut Perlet, CFO of Allianz and former Chairman of the European Insurance CFO Forum, June 2006[3]

Although there can be no certainty about when or perhaps even if IFRS 4 will give way to a new IFRS Phase II, there would appear to be a growing impetus for change. According to the IASB, 'permitting IFRS 4 to remain in place indefinitely is not a viable option'.[4] The European CFO Forum, which brings together representatives from Europe's largest insurers, has put forward its own parallel proposals on the way forward (www.cfoforum.nl), as has the Group of North American Insurance Enterprises (GNAIE) in combination with the four largest Japanese life insurers (www.gnaie.net). It is also notable that 50% of European insurance analysts attending a seminar organised by PricewaterhouseCoopers in 2006 felt that the development of a Phase II standard was needed within two years and a further 40% within three to five years.[5]

Developing a consensus between the insurance industry and accounting standard setters about what should replace the current arrangements could be difficult. However, many insurers are keen to maintain their dialogue with the IASB and reach a consensus on the finalised IFRS.

It would therefore be reasonable, in our view, to work on the assumption that IFRS 4 will give way to a modified IFRS Phase II standard in the next few years and therefore examine how the broad principles set out in the IASB's discussion paper might affect the reported earnings and organisation of the business.

## New basis of valuation

The key change from most current reporting arrangements is a move to a valuation of insurance contracts based on current estimates of future cash flows.

Where possible, the forecasts would draw on market inputs. However, as direct market inputs may not be available for all variables, insurers would need to base their evaluations on the hypothetical market price that a third party would require to take on the rights and obligations of the contract. The transfer price could be different from the premium agreed with a policyholder, with an immediate impact on the insurer's results. It would include a risk margin to reflect the compensation the acquirer would require to make up for any uncertainty in the timing and amount of the cash flows.

The ramifications of this step-change in valuation are considerable. Basing accounting on current market-consistent projections could lead to a shift in the trajectory of income, including in some cases the possibility of a day one profit or loss. For example, if a contract is priced assuming a higher or lower investment return than the discount rate used for accounting purposes, the insurer may recognise respectively a loss or a profit at inception. The need to take account of movements in market variables could also lead to volatility in the reported earnings, especially as contracts would need to be re-valued at each reporting date.

The allowance under IFRS 4 to continue to use 'excessive prudence' in insurance accounting would also disappear under IFRS Phase II. At present, for example, insurers can use a very low discount rate or build an extremely high mortality expectation into their accounting assumptions and therefore the reported 'numbers' would only be affected in the unlikely event that interest rates fell below this level or mortality exceeded it. Under IFRS Phase II, they would need to build current estimates into the accounting and could therefore experience considerably more fluctuation in the affected numbers if the underlying variables, such as interest rates and mortality, change.

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[3] Dr Perlet was speaking at the launch of the Forum's proposals for the development of financial reporting in Brussels in June 2006.

[4] 'Discussion Paper: Preliminary Views on Insurance Contracts', published by the IASB in May 2007.

[5] 'Standing up to Scrutiny: Analysts' Perspectives on Insurance Reporting', April 2006 (www.pwc.com/insurance).

## Organisational impacts

The practical process of producing valuations that draw on multiple scenario cash-flow models using current market inputs may stretch the systems and organisational capabilities of some insurers.

The impact will be especially marked in parts of Asia and Continental Europe, where insurance accounting systems are still generally based on models that do not use current cash-flow information and market variables.

However, companies that have started using embedded value or economic capital models may be ahead of the game leading into implementation. Some of the necessary capabilities may also be already in place from systems used to manage asset-liability matching or risk-based capital. For these companies, the key assessment is that the systems supporting these evaluations may need to be brought up to an auditable standard. For example, while risk margins are built into the analysis underpinning some embedded value reporting and a range of commercial transactions, systems may not be generating the extensive range of scenarios required for the evaluation of 'probability-weighted best estimates'. In addition, actuaries face a challenge in using and developing existing techniques to produce relevant and reliable risk margins.

Investment in upgrading the actuarial systems, processes and underlying controls for measures like embedded value or economic capital could help insurers to prepare for the requirements of IFRS Phase II. Naturally, improving these capabilities could also enhance the basis for decision-making and provide clearer key performance indicators to help management in assessing the strengths and prospects of the company.

As the conceptual bases for financial reporting and actuarial analysis converge (i.e. more fair value-based) and they begin to use common sources of information (i.e. models of future cash flows), there will be a growing need for closer co-operation with finance, regulatory, and risk and capital management teams. For example, analysis of sensitivity to market risk exposures (e.g. the impact on fair values of hypothetical movements in interest rates) is likely to become a more important component of financial reporting. While such analysis is already a critical element of asset-liability management (ALM) and other internal financial risk assessments, it has a relatively lower importance in the analysis of financial results, since existing accounting models tend to use non-current data and in some cases excessive, prudential margins dictated by solvency rather than economic considerations. As a result, the impact of market movements may not be reflected in liability measurements and reported results.

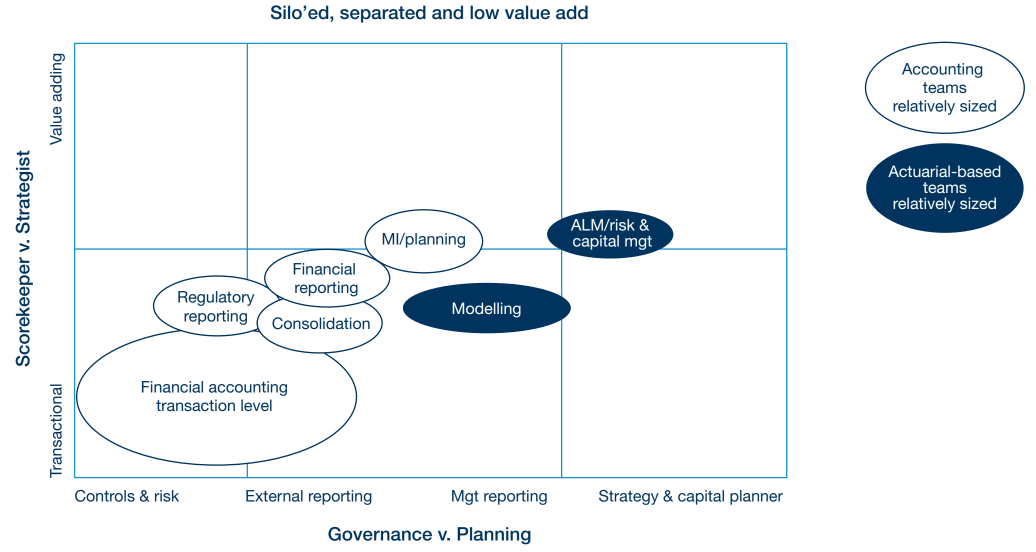
Not only is this counterintuitive, it could also lead to an ALM mismatch, as under IAS 39 market movements are reflected in the valuation of assets. Under IFRS Phase II, however, the reported results are intended to represent more faithfully the ALM and financial risk management adopted by the insurer. Combined with the current IFRS risk disclosure requirements, the financial statements would provide investors with a clearer understanding of the level of risk sensitivity in future financial results.

There are clearly challenges in developing and managing the necessary cross-functional coordination. This includes establishing ownership of IFRS Phase II and, where applicable, related Solvency II implementation. However, closer integration could help finance teams to add more value and benefit from the synergies of more streamlined operations. For example, as future cash-flow modelling becomes more widely deployed in management information and reporting across a number of departments, there will be considerable room for synergies such as common sources of data and common assumption-setting processes, along with more consistent metrics and analysis for senior management (see Figure 2 overleaf).

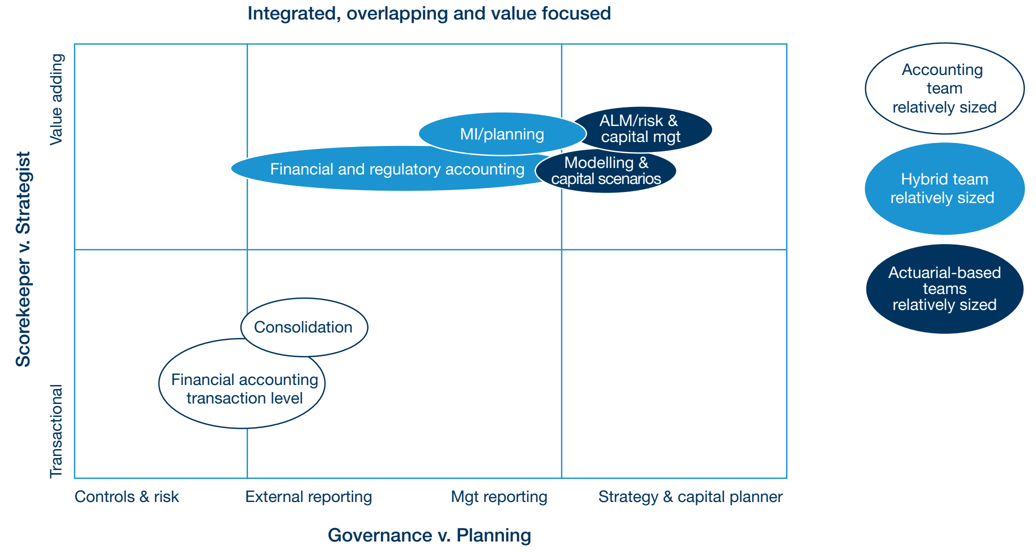
Developing the necessary consistency in data and assumptions could also prove a challenge as groups move to a single basis of accounting for insurance contracts under IFRS. This is because IFRS Phase II would no longer allow the use of non-uniform accounting practices across multinational insurance groups permitted under IFRS 4.

Figure 2 – The evolving role of finance under IFRS Phase II

### Before: The role and structure of finance in 2007




### After: The role and structure of finance – post Phase II/Solvency II




**Source:** PricewaterhouseCoopers

In summary, a proactive forward-looking approach to organisational and systems designs that looks ahead to the future convergence of analysis and reporting could help to ease implementation, streamline operations, achieve synergies and seize opportunities to enhance management information and other potential benefits.

## The right people

The new and evolving demands on reporting will inevitably put further pressure on what is already a limited supply of qualified actuaries, finance managers, project managers, and IT staff. There will be a particular premium on people who are familiar with the technicalities of the new IFRS and related aspects of Solvency II. As the demand surge for staff in the lead-up to the move to IFRS Phase I underlined, a proactive long-term approach to training and recruitment can prove less costly and more efficient than the inevitable fee and salary escalation immediately prior to implementation.

Looking ahead, we would expect to see more 'hybrid teams' in which actuaries and accountants work closely together to deliver more timely and reliable financial information and disclosure. Traditional accounting areas in which actuaries are likely to become more involved would include chart of accounts, financial reporting and disclosure.

## Project synergies

For EU-based insurers there are a number of important overlaps between the proposed Phase II and the development of a risk-based approach to regulatory capital evaluations under EU Solvency II.[6] Common requirements include:

- Current estimates of projected future cash flows;
- Quantification of risk margins; and
- Use of dynamic financial analysis.

Planning now how to achieve these synergies rather than later would help companies to avoid some of the costs and potential disruption of applying and managing the frameworks separately. In particular, common data and systems requirements underpin much of the necessary information that is likely to be required for each of these valuations and presentations.

However, there could be significant differences in the detail of Phase II and Solvency II. Key considerations include which contracts are valued as insurance, the value of customer relationships under IFRS and restrictions around valuation techniques and assumptions acceptable under Solvency II, along with differences in the level of detail for disclosures. Companies would be advised to monitor these related developments and judge how the differences could affect their reporting. They may also wish to coordinate their comments on both frameworks to influence standard setters and regulators to align their proposals.

## Initial assessment

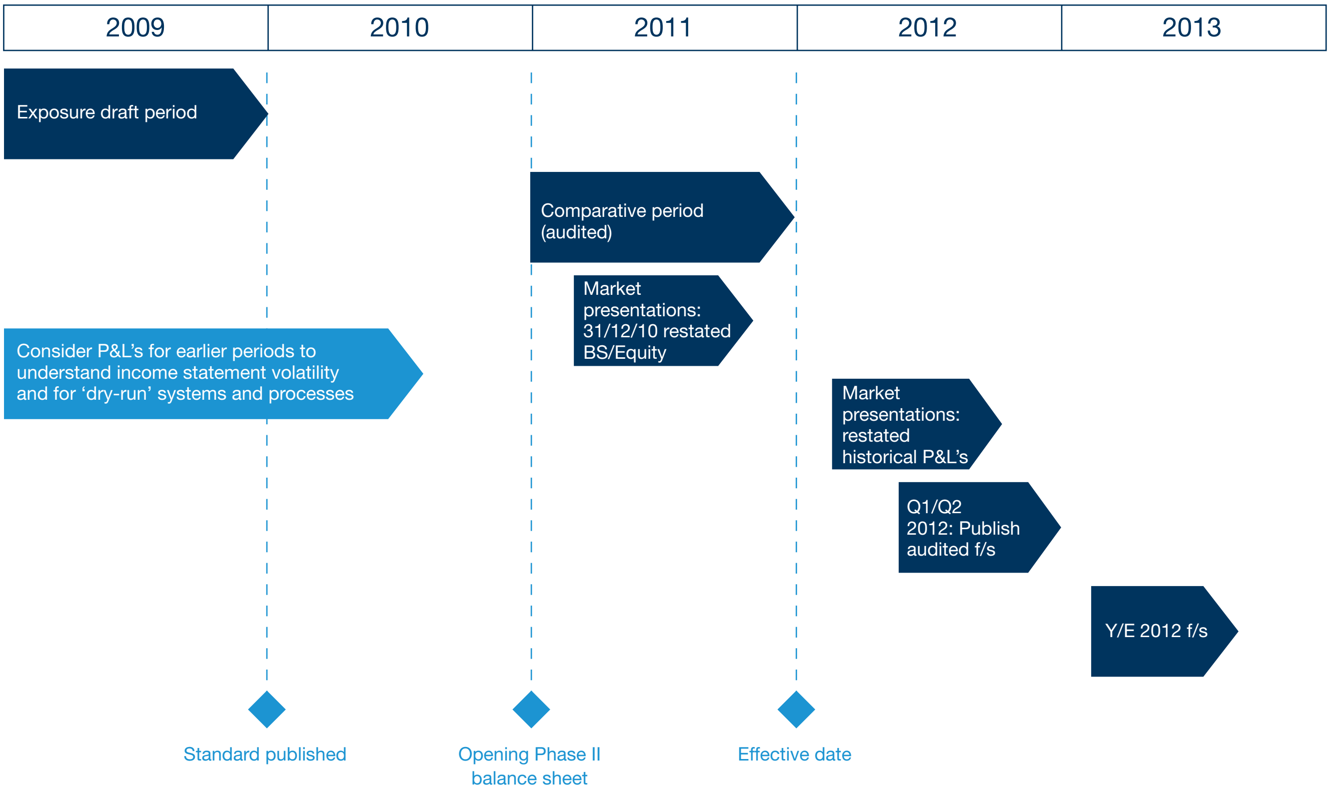
Much of the detail in the IFRS Phase II could be subject to revision. There may therefore be a natural reluctance to begin preparations before the standard is finalised. However, this may leave companies with too much to do in too little time.

The experience of moving to Phase I demonstrated the scale of the potential task. Many companies required at least three years to apply the changes and even then compliance often relied on spreadsheets and the use of outside contractors. Implementation of Phase II is likely to be a far more complex and time-consuming exercise, especially as it will require extensive actuarial input and data cleansing. Moreover, as the timetable (Figure 3 overleaf) highlights, companies will need to provide comparative information.

The issues are complex (technically and operationally) and vary from business to business and country to country and it may therefore be difficult to gain a full picture of how IFRS Phase II will affect your company at this stage. Nonetheless, carrying out an initial assessment now could help to identify the most pressing implications for your particular business and any potential gaps in operational capabilities. A particular benefit of an initial assessment is that in addition to pinpointing areas that require more immediate attention, it would also identify the areas where a company can afford to wait. Leaving everything to a later date could be risky, especially given the magnitude of change proposed in IFRS Phase II. It is not necessary to know the detailed requirements of the new standard in order to begin to prepare for it.

[6] For more information, please refer to the PwC publication, Gearing up for Solvency II: The New Business Environment, August 2007
Copies of the publication are available to download from www.pwc.com/solvencyII

Figure 3 – Overview of potential Phase II reporting timescale (assuming 2012 adoption)




**Source:** PricewaterhouseCoopers

## Valuable opportunity

Although the publication of the IFRS discussion paper clearly opens up a number of financial and operational challenges, it also represents a valuable opportunity. In particular, commenting on these proposals could help insurers to shape a financial reporting standard that conveys the full value and prospects of their business and helps them to compete for capital on a par with other industries.

The publication of the discussion paper could also prove to be a step in the convergence of US and IFRS accounting principles for insurers. The FASB is about to issue the IASB discussion paper to assess whether it should join the IASB in developing a revised insurance contract standard that will be similar to the proposed new IFRS. The comment period for US insurers is expected to end at the same time as for those under IFRS: 16 November 2007.

# Appendix: Technical overview of the IASB discussion paper

- Single accounting model for all life and non-life, insurance and reinsurance contracts;
- Model based on estimate of future cash flows that takes account of risk, duration and any services rendered;
- Risk margin is based on the compensation price to transfer liabilities. The unit of account is the portfolio, so risk pooling across the portfolio would be recognised, but company-wide diversification would not;
- Discussion paper also sets out an alternative approach geared to the premium charged;
- Service margin, in addition to the risk margin, based on the compensation to transfer servicing rights and obligations;
- Liability measures reflect credit standing of issuer;
- No deferral of acquisition costs, all costs expensed as incurred. However, the customer relationship value can capture the investment in the existing policyholder portfolio;
- Recognition of future premiums if their payment guarantees continued cover at a constrained price;
- Discretionary policy dividends qualify as liabilities if there is a ‘constructive obligation’ to pay them, leaving any residual balance to be treated as equity. The question over what qualifies as a constructive obligation, including whether it includes the need to provide competitive returns, could affect the wider debate on the accounting of instruments as debt or equity; and
- The discussion paper raises a number of open questions about how premiums and changes in insurance liabilities should be presented in the financial statements. The key issue is whether premiums should be presented as revenues or deposits.

# Contacts

**If you would like to discuss any of the issues raised in this paper please call one of the following or speak with your usual contact at PricewaterhouseCoopers.**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- IFRS Insurance Alert, May 2007
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