



# Financial Reporting Developments – the Boardroom perspective

**24<sup>th</sup> Annual Insurance  
Issues Conference**

Monday, November 30, 2015



# Topics to be discussed

**1** Insurance accounting – how we arrived here

**2** IFRS 9 – Financial instruments

**3** IFRS 4 Phase II – Insurance contracts

**4** IFRS 15 - Revenue from contracts with customers

**5** Expanded auditor reporting



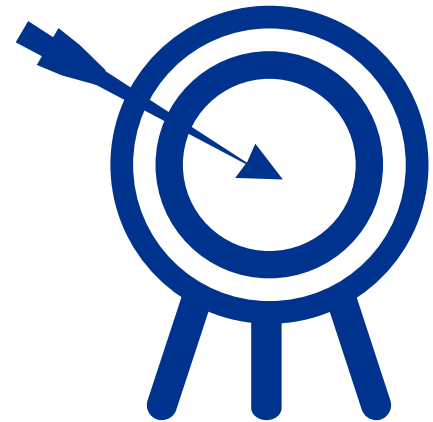
# Accounting for insurance contracts – the balancing act

The measurement goals of the insurance industry, particularly the life insurers and the IASB needed some alignment

## The Insurance Industry

**Desired an income statement that:**

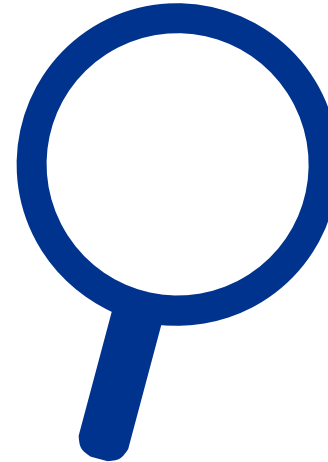
1. reflects the fact that life products are long term products; and
2. eliminates short term volatility that detracts from underlying business performance



## The IASB

**Desired a balance sheet that:**

1. reflects year end market prices; and
2. inputs used where available



# Accounting for insurance contracts: The Compromise

## Profit and loss account

- IFRS provides options to eliminate accounting volatility caused by mismatched between asset and liability valuation mismatches



## Balance sheet

- Balance sheet that reflects year end market prices and inputs where available
- Contract service margin defers profit recognition (effectively unearned profit) and provides smoothing mechanism through unlocking

## Other comprehensive income

- Repository for some volatility similar to pensions accounting for actuarial liabilities

# Why is IFRS 4 Phase II a complex standard?

The compromise has resulted in a complex standard:



## Asset Liability Mismatch

Options to eliminate volatility between movement in valuation of assets and liabilities has proven to be complex



## Different effective dates

Difference in effective dates of IFRS 9 and proposals to grant transitional provisions to insurers has increased the complexity of IFRS 4



## Participating contracts

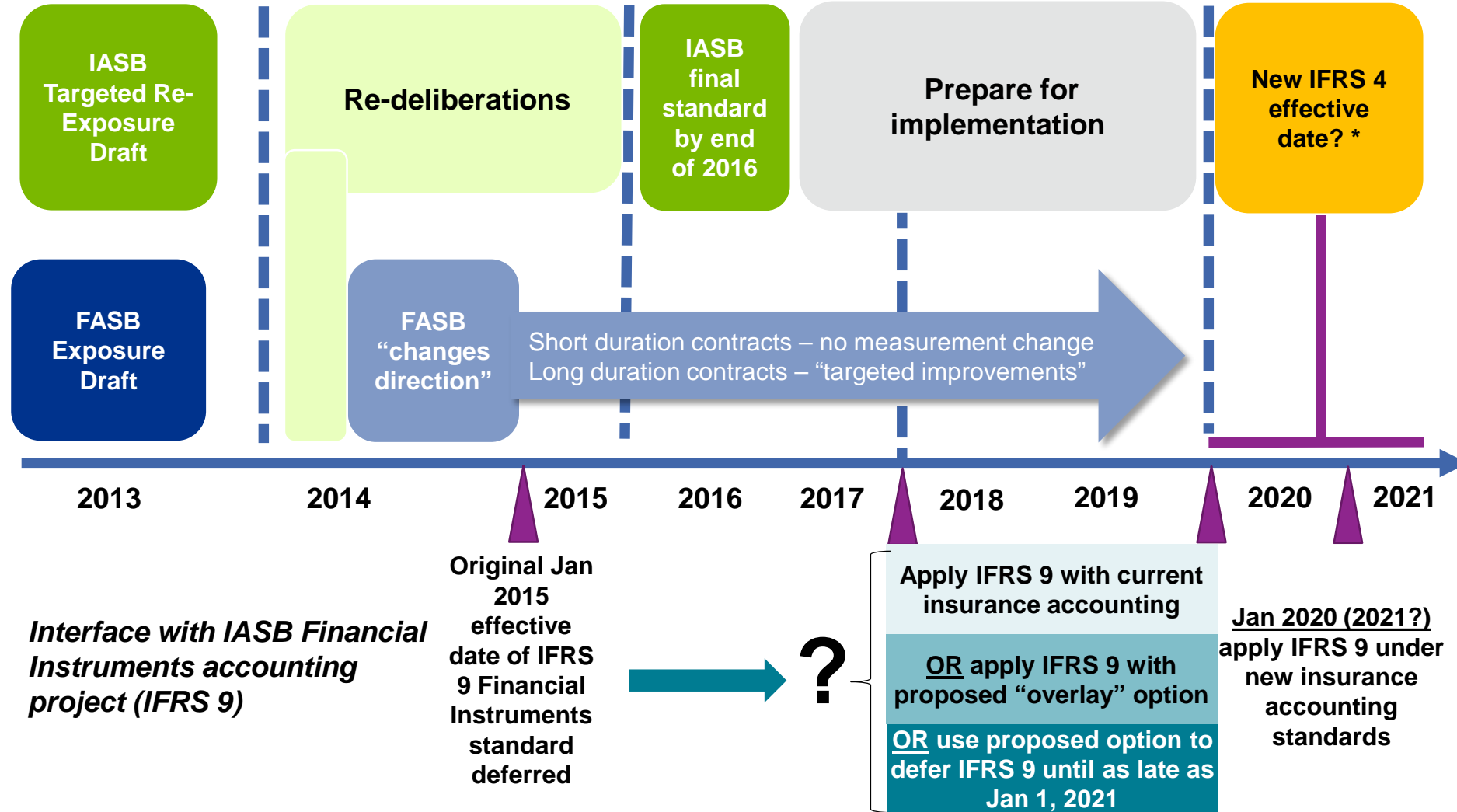
Asymmetrical nature of participating contracts for shareholders (in negative scenarios) has further increased complexity of accounting



## CSM












Initial determination and subsequent unlocking of the Contractual Service Margin is complex

# Timeline - IFRS 9 and IFRS 4 Phase II



\* The effective date of the final IFRS standard is expected to be approximately three years after the standard is issued. IASB staff currently estimate an issuance date by end of 2016 which would result in a likely effective date of annual reporting periods beginning on or after January 2020. Some preparers are asking for more time

# Overview of IFRS 9

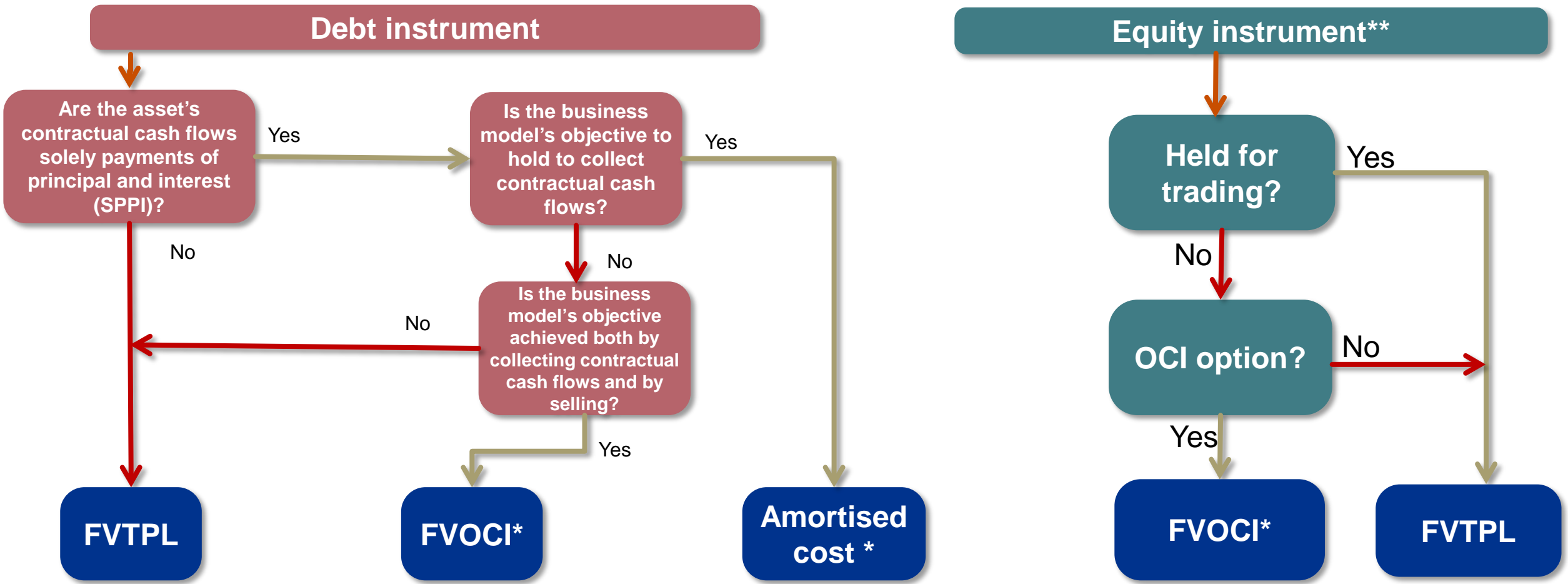
Topic	IFRS 9	Impact	
		Financial sector	Other corporates
Recognition and derecognition	IAS 39 model		
Classification and measurement	New model		 
Expected credit losses (Impairment)	New model		 
Hedge accounting	Amended model		 

## Legend:

-  Low impact
-  Medium impact
-  High impact



# IFRS 9 - Classification of Financial Assets – Debt and Equity Instruments



\* Subject to FVTPL designation option - if it reduces accounting mismatch






# Asset designations – P&C insurers

## The proposals could reduce the asset-liability mismatch for many P&C insurers

Current P&C accounting		New IFRS proposals	
		<i>OCI option</i>	<i>Fair value option</i>
	<i>Change in interest rates reflected in:</i>	<i>Change in interest rates reflected in:</i>	<i>Change in interest rates reflected in:</i>
Discounted claims liabilities	Profit and loss	OCI ↕ OCI	Profit and loss
Bonds accounted for through OCI	Other comprehensive income (OCI)		
Bonds accounted for as fair value through P&L	Profit and loss (less common choice)		Profit and loss
Common problem in current P&C accounting is unmatched discounting of claims liabilities in P&L		Proposals would allow effect of interest rate changes to go through either P&L or OCI – your choice!	

Possible mis-match

# IFRS 9 asset designations – life insurers

Asset	Current prevailing designation	Designation under IFRS 9 – 2018 <sup>3</sup>	Designation under IFRS 9 – IFRS 4 phase II	Comments
Bonds backing insurance contracts	FVTPL (fair value through profit and loss)	FVTPL	FVTPL	<i><u>Unchanged</u> – expect Cdn lifecos to use FVTPL rather than OCI</i>
Bonds backing surplus	AFS <sup>1</sup> (available for sale)	FVOCI <sup>1</sup> (fair value through OCI)	FVOCI <sup>1</sup>	<i><u>Unchanged</u> - FVTPL option not available for bonds backing surplus</i>
Stocks backing insurance contracts	FVTPL	FVTPL	FVTPL	<i><u>Unchanged</u> – expect Cdn lifecos to use FVTPL rather than OCI</i>
Stocks backing surplus	AFS <sup>1</sup> 	FVTPL	FVTPL	<i>FVOCI unattractive for equities<sup>1</sup></i>
Loans and receivables	Amortized cost	Amortized cost 	FVTPL (for assets backing insurance contracts) <sup>2</sup>	<i>Without CALM, likely require FVTPL to improve matching</i>
Mortgages	Amortized cost	Amortized cost 	FVTPL (for assets backing insurance contracts) <sup>2</sup>	<i>Without CALM, likely require FVTPL to improve matching</i>

1 – AFS and FVOCI both reflect income on an amortized cost basis, and unrealized market value changes in other comprehensive income (OCI). However, FVOCI is unattractive for equities since realized gains are not recycled through income.

2 – FVTPL available for loans, receivables and mortgages under IFRS; use of FVTPL dependent on final OSFI decision to remove the prohibition of FV in Guideline D-10

3 – Unless proposed option to defer implementation of IFRS 9 is taken.

# IFRS 9 transition options for insurers

## **Deferral Approach**

**Defer application of IFRS 9 and continue applying IAS 39 Financial Instruments: Recognition and Measurement (IAS 39) until the earlier of 2021 or adoption of the forthcoming insurance contracts standard**

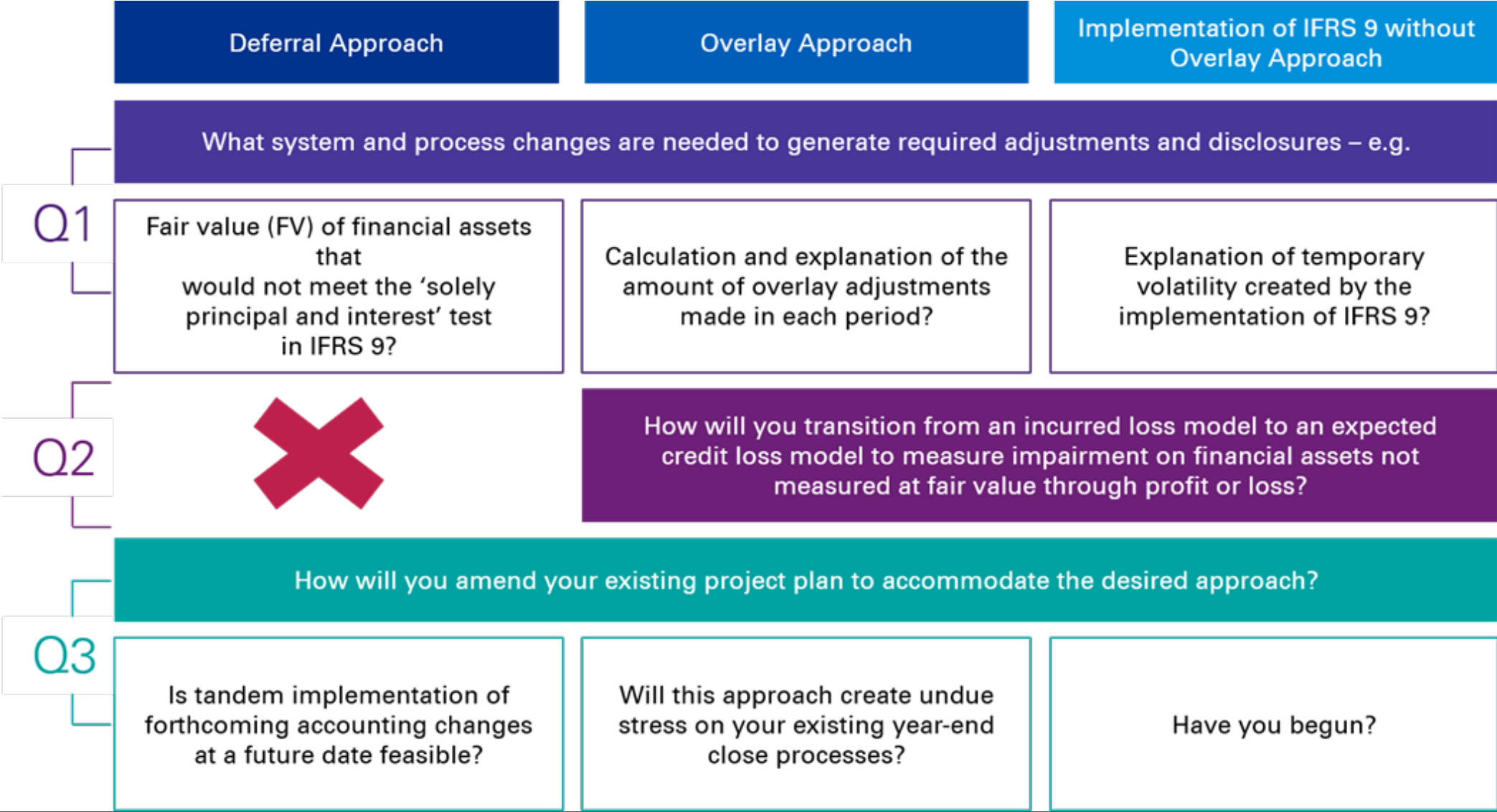
## **Overlay Approach**

**Implement IFRS 9 and reclassify the difference between amounts recognized in profit or loss under IAS 39 and IFRS 9 to OCI**

## **Implement IFRS 9 without Overlay Approach**

**Apply IFRS 9 retrospectively, in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, except as specified.**

# Choosing the right approach





# IFRS 4 Phase II and current practices

## Comparison of IASB model to Canadian life insurance basis (CALM)

CALM also starts with a probability-weighted estimate of future cash flows  
IFRS proposals exclude tax cash flows and some expenses

CALM reflects the insurer's own asset portfolio returns, which are normally higher than low-or-no risk interest rates

CALM includes "margins for adverse deviations" that are higher, since they include margins for asset risks such as future defaults

No counterpart in CALM, which allows both gains and losses at inception, and immediately recognizes best estimate changes in P&.

## Four Building Blocks

### BB1 - Expected future cash flows

Explicit, unbiased and probability-weighted estimates of future cash outflows less future cash inflows

### BB2 - Time value of money

Discounted using current rates to reflect the time value of money - not linked to assets actually held

### BB3 - Risk adjustment

To adjust for the effects of uncertainty about the amount and timing of future cash flows

### BB4 - Contractual Service Margin

To remove any profit at inception. Adjusted prospectively (for changes in BB1 and BB3) and released over coverage period

# IFRS 4 Phase II compared to current practices

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## Four Building Blocks

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## Measurement Changes Expected

*Future expense will be lower - only directly attributable costs included, reducing this element of policy liabilities. - **Small reduction in policy liabilities***

*Top down rate alternative - deduct risks not present in liability, and able to adjust observable market inputs to set more stable discount rates at unobservable long durations. **Likely increasing liabilities.***

*Risk adjustment similar, but will not cover asset-related PfADs such as asset default risk and mismatches, **reducing liabilities.***

*New business strain still recognized, but day one gains deferred in the CSM, **increasing liabilities.** CSM CSM unlocked to absorb assumption changes. **Recognition of profit and of profitability change is slower.***

# Measurement and other impacts

## P&C insurance

**Acquisition costs  
definition changed**

**Little impact on many companies; some may actually have somewhat higher acquisition costs recognized against UPR than are in their current DACs, and hence higher equity and capital available**

**Deferred acquisition  
costs no longer an  
asset (included in  
liabilities)**

**Effectively nets DACs against unearned premium liability – mostly a geography issue, easily solved through recalibration of OSFI capital model**

**Premium allocation  
approach definition of  
“unearned premium”**

**Expect minimal net measurement impact on income and equity. Note application of time value of money, however**

# Measurement and other impacts

## P&C insurance (2)

**Onerous contracts more likely to be identified, as a result of using a portfolio definition**

**More likely to see write-offs and decline in available capital when a portfolio is determined to be loss-making (think auto insurance when there is a combination of high claims costs and regulatory constraints)**

**Transitional impact on capital expected to be significant for P&C?**

**Overall, impacts on asset and liability valuations are not zero, but appears unlikely that the net impact on equity at transition would be dramatic for most P&C insurers**

**Emergence of income**

**Where premium allocation approach applies, emergence of income likely to be similar to current unearned premium model**

**Optional use of OCI to capture interest rate volatility in liabilities could reduce P&L volatility – but so would use of fair value option**



# Measurement and other impacts

## Life insurance

**BB1 – expenses as defined may be lower for some**

Future expenses will be lower for some, reducing this element of policy liabilities. Also need to consider changes in acquisition expenses. Discounted future tax liabilities will be excluded from insurance liability measurement. Overall impact – perhaps mildly reducing policy liabilities

**BB2 – lower discount rate could overwhelm all other changes**

Overall, expect that a “top down” discount rate will still be lower than current valuation rates, and below the rates typically priced into many products – resulting in potentially large increases in liabilities for some products, possibly with losses at inception

Disconnect between liability and asset rates will result in greater volatility

**BB3 – risk margins would not cover some areas of current PfADs**

Risk margins similar for some elements, but will not cover asset-related PfADs such as asset default risk and mis-matches, reducing policy liabilities. (Note that some asset default provisions will reappear in assets under IFRS 9)

# Measurement and other impacts

## Life insurance (2)

**BB4 – Contractual Service Margin precludes Day 1 gains for new business**

**CSM would soak up any reserve reductions from BBs 1 and 3. If not overwhelmed by the effect of lower discount rates, CSMs represent a new liability component**

**Where we have had Day 1 gains in the past, the CSM moves those profits out of retained earnings**

**Disclosures**

**Risk margin – need to disclose confidence level inherent in the risk margin, even if that is not the method used**

**Revenue – change from “premiums due” to the new definition will be complex and require significant changes to reported revenue**

**Volatility from discounting**

**Without CALM’s asset-liability valuation linkage, volatility from discount rate changes will be much greater**

**The use of the OCI option would reduce interest rate volatility in the P&L, but it would still exist in equity through accumulated OCI.**

**Volatility from other liability measurement changes**

**Other re-measurements, favourable and unfavourable, will be smoothed out through adjusting (“unlocking”) the Contractual Service Margin, rather than immediate recognition in income**

**Capital impacts would be both positive and negative, but regulators might be inclined to focus on adverse changes.**

# Measurement and other impacts

## Life insurance (3)

### Emergence of income

Profit from new business will be lower – new business strain (losses at inception) might be lower for some products, but for other products there will be no profits at inception

Similarly, no immediate gains from reinsurance ceded. On balance, the new CSM may result in slower recognition of *changes* in profitability

### Transitional impact on capital expected to be significant for life?

Lower discount rates (BB2) and CSMs (BB4) could significantly exceed other measurement changes and result in a significant reduction in retained earnings on transition

### Taxation

Will taxation authorities continue to follow accounting reserves? Will measurement changes be transitioned in over several years? Deferred tax balances may be created

Deferred tax assets may increase and result in valuation concerns for IFRS accounting, and may not count fully for regulatory capital purposes

# IFRS 4 Phase II – the business implications

## Secondary impacts beyond financial reporting



### Management Incentives

How will

- transition accounting adjustments; and
- new business metrics

affect management incentive schemes?



### External Expectations

How will

- analysts communications and
- Financial covenants and targets

be affected?

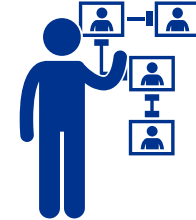


### Regulators

How will

- regulatory capital where regulatory return starts with IFRS financial statements

be affected?



### Internally

How will

- Governance over IFRS convergence projects
- Changes to asset mix and duration

be managed?



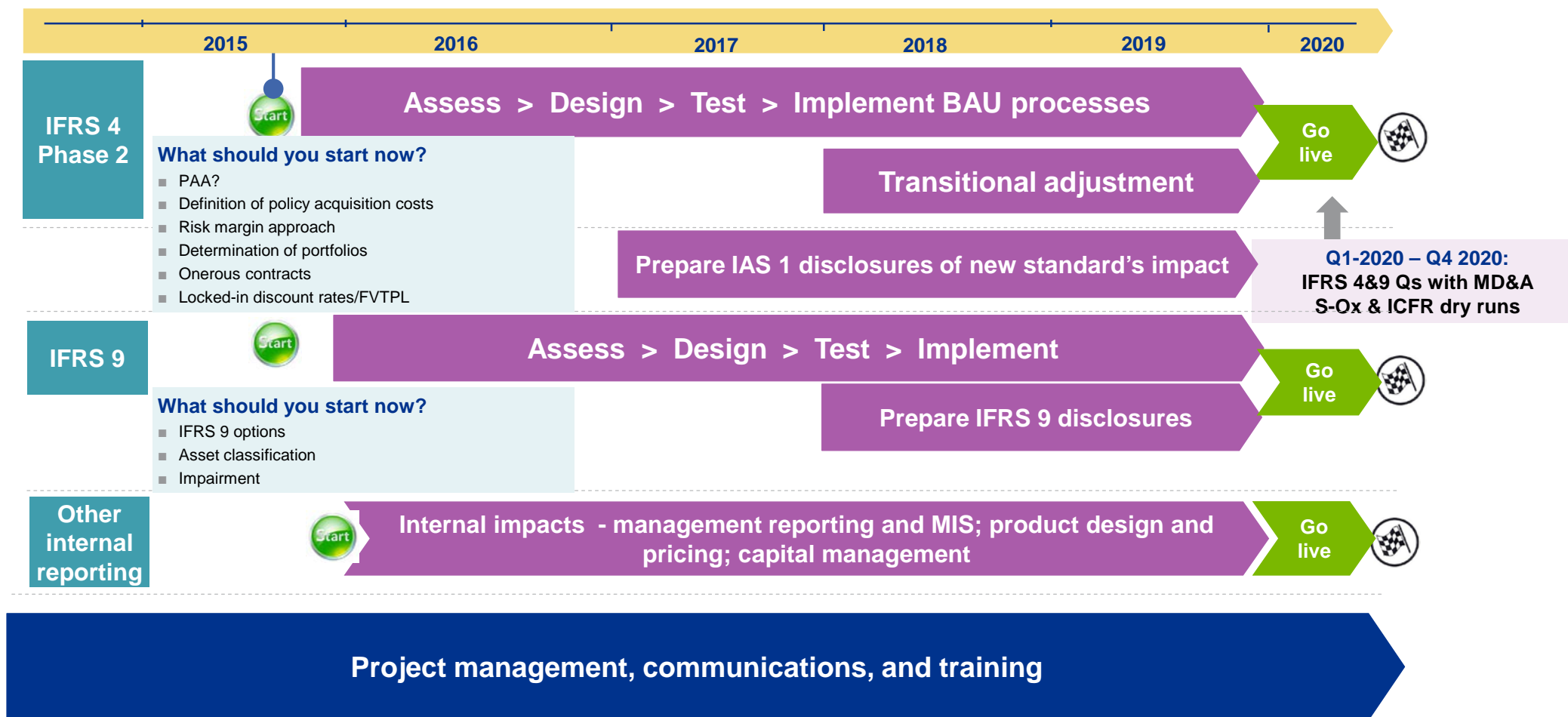
## Shareholder reporting

- **Increased complexity especially on transition and restatement exercise and interaction with IFRS 9**
- **Potential increased volatility in the income statement**
- **Deferral of profits with Contractual Service Management (“CSM”) (major impact on profit recognition patterns for certain products)**
- **Likely that explaining changes in CSM will be a key focus to demonstrate value created from new business sold in the period, the timing of when this profit will be recognized and impact of unlocking of the CSM in the period**
- **Likely that existing KPI metrics will need to be revisited and new KPIS designed**
- **Revised reporting metrics may result in product re-design**

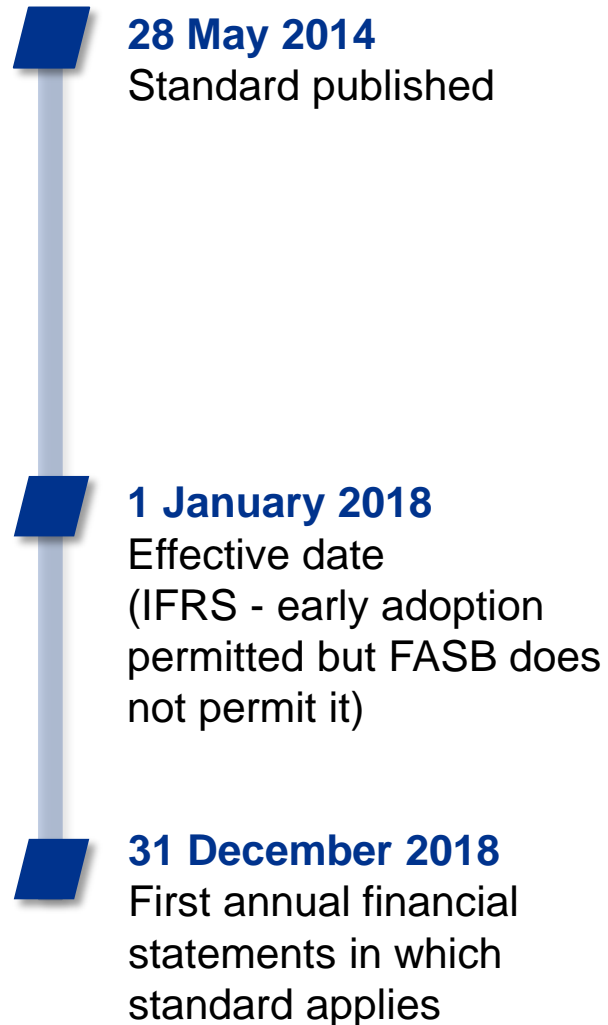


# High level project management timeline...

\* Assumes 2020 implementation date for the forthcoming insurance standard, and use of proposed IFRS 9 deferral option



# IFRS 15 Overview of Revenue from contract with customers



## Overview

- Key issues when and how to recognize revenue
- For insurers issue are likely to focus on recognition of administration fees and charges bundled with insurance contracts
- For intermediaries key areas are profit commissions and fees based on performance outcomes
- May accelerate timing of recognition from cash is received to either expected probability weighted amount or most likely amount

# Enhanced auditor report – current status

## Countries applying International Auditing Standards

**Enhanced Auditor Reporting is effective for period ending on or after 16 December 2016.**

## Canada

**Latest consultation period ended October 2015.**

## USA

**Revised proposals expected Q4 2015.**

## UK

**Enhanced auditor reporting now in force for over 2 years**



# USA - Comments on PCAOB proposals

"No, the auditors communication of critical audit matters **would not be relevant** and useful to investors and other financial statement users"

New York State Society of Certified Public Accountants - December 10, 2013

"We are concerned that the inclusion of one or more critical audit matters **would not be additive** to the financial statements users' understanding and obscure the actual pass / fail conclusion"

Capital Group December 9, 2013

"We continue to recommend that the description of critical audit matters in the auditors report **exclude** audit procedures performed or an indication of the outcome of the auditors procedures and significant auditor judgements"

Blackrock –October 30,2013

"Disclosure of Critical Audit matters will confuse investors and other financial statements users and **may erode their confidence** to invest"

Fidelity – December 11, 2013

# UK - Challenges in implementation

- In the UK, enhanced auditor reporting coincided with other significant reporting initiatives including the new Strategic Report by Directors commenting on the business and the enhanced Audit Committee Reporting which included commentary about the key judgments concluded on by the audit committee. The fact that in UK all requirements fell under the remit of a **single regulatory body**, the Financial Reporting Council, assisted matters.
- The process required a **cultural change** to increased transparency of reporting by all parties, management, the audit committee and auditors.
- Reporting requires some additional **co-ordination** between management, the Audit Committee and Auditor around drafting of reports to ensure broad consistency on the matters and themes being reported on within each of the Strategic Report, the Audit Committee Report and the Enhanced Auditors report
- Significant effort required to **tailor** the Enhanced Auditors report to individual company circumstances and **avoid boiler plate and generic or bland disclosure or excessive number of critical audit matters**

# UK - Additional content of Enhanced Auditors Report

- Description of **areas of key auditor focus** i.e. where risk of material misstatement was considered high and for each such area:
  - Relevant financial statement caption, its quantum and page references to Audit Committee Report, Accounting Policy and Notes
  - A description of nature of the risk and its impact on the financial statements
  - The auditor's response describing auditor procedures undertaken, including the evaluation of controls and the approach taken to the testing of management's assumptions and substantive testing
  - For some entities, a description of the findings of our audit testing and the outcome if errors were detected
- Paragraph describing the application of **materiality** and a statement of the materiality thresholds applied. A description of the scoping of the work performed and coverage of the audit by financial statement caption or geographical coverage including how the work of how subsidiary teams were monitored.

# UK Investor Feedback

In a KPMG UK report published in May 2014, on the experience of the first year's experience, Ian Richards, Head of Governance and Responsible Investment at Threadneedle Asset Management stated:

“We have been **pleasantly surprised** by the usefulness of some of the disclosures. We are seeing audit committee and auditor reports being actively circulated and discussed among shareholders as part of the normal review and discussion regarding companies.”



## Conclusions of a recent academic survey

Research paper by Lauren C Reid, Joseph V Carcello, Chan Li and Terry L Neal of the Universities of Pittsburgh and Tennessee published in July 20, 2015 entitled “**Are Auditor and Audit Committee Report Changes Useful to Investors - Evidence From the United Kingdom**” concludes the following:

“...we find that additional audit committee and auditor disclosures are useful to investors as provided by significantly higher abnormal trading surrounding the release of the new reports. Furthermore, we find abnormal trading volume increased more for companies with weaker information environments. Additionally, we find evidence that companies employing auditors that tend to provide more (less) detailed audit reports experience more (less) abnormal trading volume. **Overall, it appears that additional required disclosures from audit committees and auditors provide useful information to investors.**”

# Closing comments

- UK practice **continues to develop** with more auditor reports containing audit findings
- For certain UK entities which are listed on both London Stock Exchange and New York Stock Exchange SEC Registrants e.g. HSBC, RBS investors **can choose** between an enhanced auditor report by looking at UK Annual Report or a standard US auditors style opinion if they review Form 20F.

# Thank you!

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