



# Accounting Update

## CIAA Seminar

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**INSURANCE CONTRACTS UNDER  
IFRS EXPOSURE DRAFT**

# Background

## Insurance project

- The IASB working on improving insurance accounting for over 10 years.
- Preliminary intention in 2007 to create a fair value approach – direction now focused on an entity specific model.
- The FASB joined the insurance accounting project in 2008 to achieve convergence.
- The Current Exit Value Model (fair value/transfer notion) was abandoned, and the Current Fulfillment Model was settled upon.
- Some areas of disagreement remain, and resulted in the IASB publishing its exposure draft without the FASB.
- FASB has since published a consultation paper to provide their views.

# Background

## Intended improvements to insurance accounting

- Outline a comprehensive framework that will require insurers to provide information relevant to users of financial statements for economic decision-making.
- Eliminate inconsistencies and weaknesses in existing practices and IFRS 4 Phase I.
- Provide comparability across entities, jurisdictions and capital markets.

## Working Groups

- There are a number of working groups which have been established in Canada for the purpose of preparing a formal response to the exposure draft.
  
- Canadian interests are represented by:
  - Insurance Bureau of Canada
  - Canadian Life and Health Insurance Association
  - Insurance Accounting Task Force (AcSB)
  - Canadian Institute of Actuaries
  - Office of the Superintendent of Financial Institutions
  - Companies preparing their own formal responses
  - Big 4
  - Others

## Summary of the ED proposals

- Current IFRS 4 definition of “insurance” modified slightly - requirement to have at least one scenario that creates an overall loss on the contract for the insurer.
  
- Single prospective measurement model for:
  - life and non-life businesses; and
  - insurance and reinsurance contracts.
  
- Measurement model uses a “**building block**” approach:
  1. Present value of fulfilment cash flows;
  2. Risk adjustment; and
  3. Residual margin.
  
- Modified measurement model for short duration contracts (includes determination of pre-claims liability).

## Summary of the ED proposals (cont,d)

- Measurement is current, i.e. no locking-in of assumptions.
- Measurement objective based on a “fulfillment of obligations” notion.
- No profit recognition allowed at inception of the contract – a residual margin liability is added to the building blocks amount.
- Day-one losses recognised in P&L immediately.
- Non-incremental acquisition costs are expensed as incurred.
- Timetable
  - There is a 4 month comment period, ending on 30 November 2010.
  - Target date for the publication of the final IFRS remains the end of June 2011.

## Fulfilment cash flows (Block 1)

- Explicit, **unbiased and probability-weighted** estimate of future cash flows.
- Includes all incremental cash flows that will arise as the insurer fulfils the insurance contract (including incremental acquisition costs).
- Cash flows included if arise within the “contract boundary”.
- Cash flows **re-assessed** at each reporting period.
- Reflects entity’s estimates, but estimates of market variables (e.g. interest rates) shall be consistent with observable market prices.

## Question 2 – Fulfillment cash flows (paragraphs 17(a), 22–25, B37–B66 and BC51)

- (a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?
- (b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

- Responses generally support the measurement of insurance contracts using the fulfillment cash flow model.
- Clarity requested surrounding the range of scenarios to be included in estimate of cash flows (B38 and B39).
- Stochastic modeling is generally unnecessary to arrive at reasonable and unbiased estimates.
- Common belief that all relevant expenses related to insurance contracts should be included or at least considered (i.e. general overheads and non-incremental acquisition costs).
- Feedback suggests that the application guidance is at the right level of detail.

## Fulfilment cash flows (Block 1)

### Contract Boundaries

- Measurement of an insurance contract shall include premiums and other cash flows (e.g. claims and expenses) resulting from those premiums, only if:
  - insurer can compel policyholder to pay premium.
  - premiums are within boundary of that contract.
  
- Boundary is point at which the insurer either:
  - is no longer required to provide coverage.
  - has the right or practical ability to reassess the risk of the policy holder and reset pricing of that risk.

## Question 9 – Contract boundary principle

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

- Responses have demonstrated mixed views on contract boundary principle.
- Some believe it reflects well the distinction between in-force and new business.
- Suggested improvements include refining definition as it relates to contracts subject to regulatory/statutory price controls.
- Other comments revolve around contract boundaries for purchased reinsurance (i.e. for those contracts that the cedant has yet to issue).
- Application unclear in situations where life / health contracts are involved (i.e. when re-pricing does not reflect full risk of policy holder – individual vs. group contracts).

## Time value of money (Block 2)

- Adjusts first building block for time value of money.
- Discount rate based on
  - Characteristics of the insurance liability (i.e. currency, duration, liquidity).
  - Consistent observable current market prices .
  
- **Not linked** to assets of the entity, except:
  - In limited instances where the amount, timing or uncertainty of cash flows depend wholly or partly on the performance of specific assets.
  
- Discount rate is a market consistent “risk free rate”, adjusted for **illiquidity** characteristics of liability cash flows.
  - Liquidity risk of liability is different from the liquidity risk of supporting assets.

## Question 3 – Discount rate (paragraphs 30–34 and BC88–BC104)

- (a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability? Why or why not?
- (b) Do you agree with the proposal to consider the effect of liquidity, and with the guidance on liquidity (see paragraphs 30(a), 31 and 34)? Why or why not?
- (c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long-duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why? For example, should the Board reconsider its conclusion that the present value of the fulfillment cash flows should not reflect the risk of non-performance by the insurer?

- Has generated a mixed bag of responses.
- Those for the use of a discount rate reflective of the liability suggest that the use of an asset-based rate leads to results where an entity can produce a liability by simply switching its portfolio of assets.
- Those against suggest that it creates unwanted volatility by introducing market dependent factors not tied to the fulfillment cash flow model.
- Insurers manage their obligations arising from insurance contracts through the acquisition of assets to support the cash flows. Delinking therefore creates a mismatch.
- There is a general call for additional guidance surrounding the determination of a liquidity premium.
- Alternative approaches to the calculation of liquidity premium involve backing into it after deducting credit risk (which is well supported by market data) from market risk spread.

## Risk margins (Block 3)

- Defined as “*the **maximum** amount an insurer would rationally pay to be **relieved of the risk that the ultimate fulfilment cash flows exceed those expected***”
  
- A margin to reflect uncertainty in the estimate of fulfilment cash flows. Consider
  - Risk of low frequency/high severity events
  - Contract duration
  - Width of probability distributions
  - Entity’s experience with cash flows and product
  
- Included in the measurement **explicitly and re-measured** at each reporting period.
  
- Estimated at level of portfolio of insurance contracts.
  - Effects of diversification between portfolios of insurance is not allowed.
  - Techniques **limited** to confidence interval, conditional tail expectation (CTE); and cost of capital for estimating the risk adjustment.

## Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123)

- (a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?
- (b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?

- Most propose changes to wording, in one form or another, defining risk adjustment (i.e. maximum).
- Respondents taken back by prescriptive nature of proposed techniques.
- Limits ability to use more meaningful and relevant techniques where options are available. Also negates the use of more sophisticated techniques in the future.

## Question 5 – Risk adjustment (paragraphs 35-37, B67-B103 and BC105–BC123) (Cont.)

(c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90(b)(i))? Why or why not?

(d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (ie a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?

(e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

- Confidence interval disclosures are likely to be misleading and lack comparability across methods.
- Limited experience with how to measure CTE or CoC results on a CI basis.
- General consensus is that the risk adjustment should be measured at portfolio level.
- Some challenges in application brought to light where a contract may be part of multiple portfolios.
- Diversification is often discussed while some papers also suggest that the term ‘portfolio’ needs to be refined.
- Guidance needs to be expanded in order to ensure comparability amongst insurers (in the event that the limitations to the techniques are upheld).

## Residual margins (Block 3)

- A residual margin arises when:
  - PV of future cash inflows > PV of future cash outflows + risk adjustment
  
- Eliminates any gain at inception of the contract.
  - Losses must be recognised immediately
  
- Measured at initial recognition and recognized **over coverage period**.
  - Interest accreted using discount rate locked-in at inception.
  
- Estimated at level of portfolio of insurance contracts, with same inception date and similar coverage duration.
  
- Composite margin, preferred by the FASB, combines risk and residual margins.

## Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133)

- (a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?
- (b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?
- (c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?

- Responses to (a) are typically in agreement. Albeit there are a few outliers.
- Many argue that the calculation of the residual margin is flawed and misleading as it does not take into account cash flows from non-incremental acquisition expenses.
- Most are in agreement with the treatment of day one losses but some cite inconsistencies with the application to reinsurance.
- Belief is that the level of aggregation should be at the portfolio level, but that more guidance is needed on what is intended by similarities suggested (i.e. provide examples).

## Question 6 – Residual/composite margin (paragraphs 17(b), 19–21, 50–53 and BC124–BC133) (Cont.)

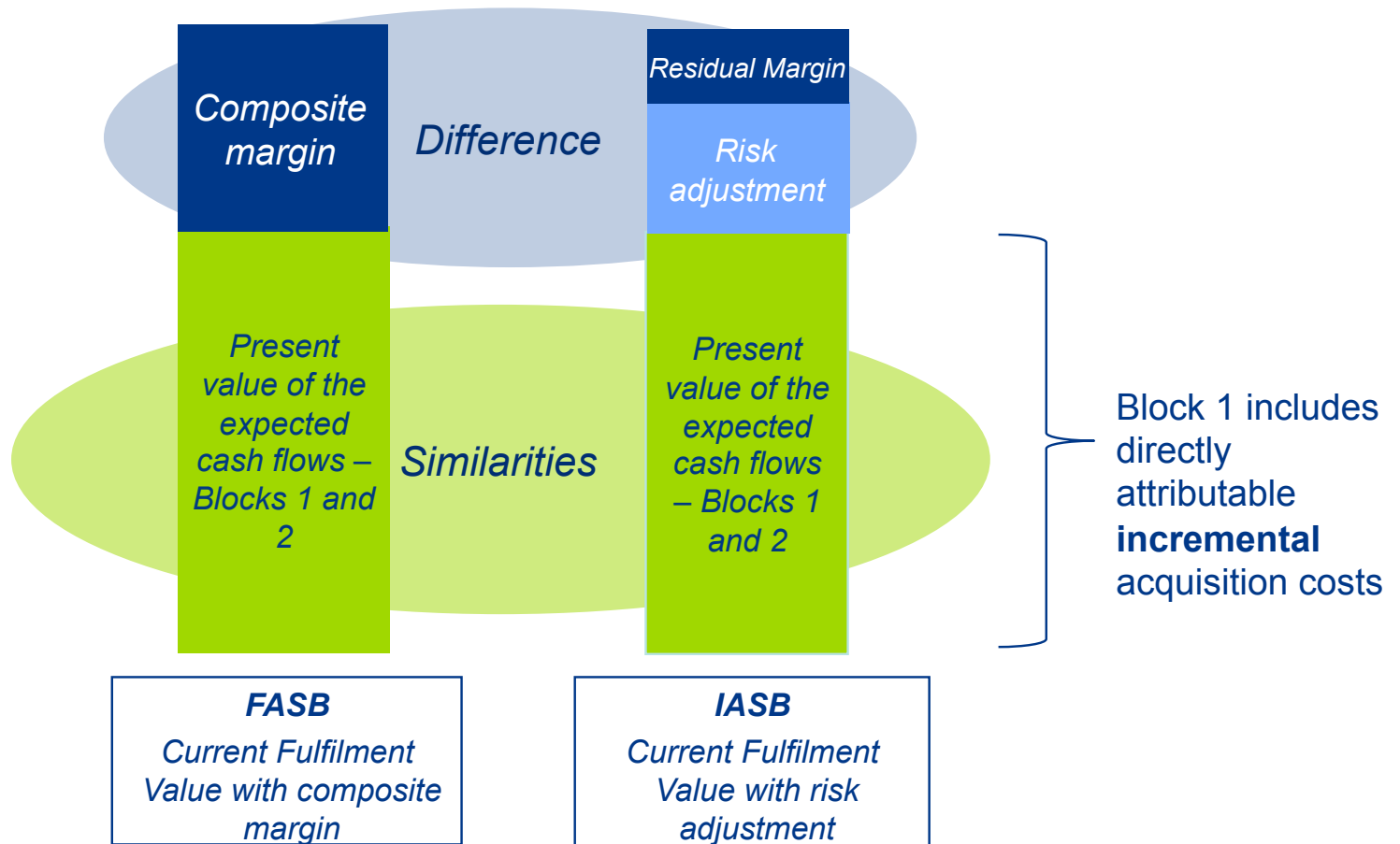
(d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why (see paragraphs 50 and BC125–BC129)?

(e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin (see the Appendix to the Basis for Conclusions)? Why or why not?

(f) Do you agree that interest should be accreted on the residual margin (see paragraphs 51 and BC131–BC133)? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

- Most disagree with the proposed method of releasing the residual margin.
- Under the proposals onerous contracts will inadvertently continue to reflect a profit.
- Proposals made to have the residual margin recalibrated in subsequent periods to reflect changes in assumptions.
- Release period should be reflective of expected pattern of obligation fulfillment.
- Helps to mitigate accounting mismatches stemming from re-estimation of cash flows for building blocks 1 and 2.
- Requirement to accrete interest introduces additional complexity with little to no added benefit.

# Margin approaches – FASB vs IASB



## Question 4 – Risk adjustment versus composite margin (paragraphs BC105–BC115)

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reason(s) for your view.

- Consensus is that most respondents prefer risk adjustment and residual margin over composite margin.
- Two are inherently different.
- More reflective of economics and business of insurers.

## Acquisition Costs

- **Incremental** acquisition costs (determined at the contract level) should be included in the present value of the fulfilment cash flows upon initial recognition.
- Incremental acquisition costs are defined as the costs of selling, underwriting and initiating an insurance contract.
- Only for issued contracts.
- All other (i.e. non incremental) acquisition expenses are expensed as incurred.

## Question 7 – Acquisition costs (paragraphs 24, 39 and BC135 –BC140)

(a) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

- Consensus is that definition of incremental acquisition costs is too narrow in scope (i.e. commissions to brokers vs. salaries of direct writer employees).
- Comments generally support the proposal to include marketing and underwriting expenses in determination of cash flows.
- Suggest definition be elevated from contract level to portfolio level.
- Exclusion of these costs not captured by the current definition may result in inflated residual margins calculated on origination.
- Supports the fact that insurance contracts are priced to recoup all acquisition costs and overheads.

## Pre-claims liabilities and Short duration contracts

- Pre-claims liability for all contracts that have:
  - A coverage period of approximately one year or less; and
  - No embedded options or derivatives that significantly affect the variability of cash flows
- Measure pre-claims liability by **allocating premiums** over coverage period:  
At initial recognition = premium received + expected PV of future premiums  
less incremental acquisition costs
- Full amount will be earned over the coverage period.
- The **post-claims liability** will be recognised as claims incurred measured using three building blocks.
  - After the coverage period models align with a post-claim liability (i.e. building blocks)
- Results in simpler measurement for the pre-claim liability (first 12 months or less).

## Question 8 – Premium allocation approach

- (a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?
- (b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

- General consensus is that the Board should not introduce a modified measurement approach.
- At a minimum, it should be permitted, not required.
- Modified measurement model appears to have its own complexities in that it requires onerous contact test and need to account for post claims liabilities.
- Has unintended consequences as it relates to reinsurance and some long-duration contracts (i.e. surety contracts).
- Accretion of interest would generally have an immaterial impact while incurring unnecessary costs to track.
- Alternatives proposed included earned/unearned premium method similar to that currently being used.

## Other measurement items

- Unbundling contracts:
  - E.g. - investment account, embedded derivatives, unrelated service elements
  
- Recognition/Derecognition of contracts:
  - Recognize when insurer becomes a party to the insurance contract
  - Derecognition follows IAS 39 (discharged, cancelled or expires)
  
- Reinsurance:
  - Measured using the building-blocks as insurance contracts
  - Reinsurance assets held by cedants should be measured with reference to the reinsured liability
  - Cedants must apply an expected credit loss adjustment to reflect present and future impairment on a probability weighted basis.
  
- Guidance on portfolio transfers and business combination.

## Question 16 – Reinsurance

- (a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?
- (b) Do you have any other comments on the reinsurance proposals?

- Comments are generally supportive of expected loss model for reinsurance assets.
- Requests made for the Board to clarify whether cedants should measure its reinsurance assets on the same basis as its underlying direct insurance (reflected in basis for conclusions but did not make it into the ED).
- Not clear how modified measurement approach applies to reinsurance.
- Contract boundary should be aligned for both insurance and related reinsurance contracts.
- In general, reinsurance appears to have been addressed as an afterthought.

# Presentation

## Statement of comprehensive income

- The new presentation model in the ED has been developed from two key conclusions:
  1. Presentation of an insurer's profit or loss is better expressed from the building-blocks model; and
  2. A margin approach is the most suited presentation to display the sources of profit from the building-blocks model.
  
- An insurer shall NOT present (except for short duration contracts):
  - Premiums
  - Claims expense and other expenses included in the measurement of insurance contracts

# Presentation

## Statement of comprehensive income (cont'd)

- To ensure consistency in the application and greater comparability there are five minimum line items to be put on the face of the income statement:
  - i. Underwriting margin;
  - ii. Day one losses on insurance sold and day one gain on reinsurance bought;
  - iii. Acquisition expenses (non incremental); and
  - iv. Experience variances and changes in assumptions;
  - v. Interest expense from discount unwinding (ideally paired with an asset investment income line to display an investment margin).
  
- For short duration contracts that are using the unearned premium method, present:
  - Premium revenue
  - Claims and other expenses
  - Incremental acquisition costs

## Presentation (cont.)

<b>i. Underwriting margin</b>	
a. Income from residual margin	+
b. Income from opening risk adj.	+
c. Changes in closing risk adj.	±
<b>ii. Experience variances and changes in assumptions</b>	
d. Experience variances	±
e. Changes in closing cash flow estimate	±
f. Changes from closing discount rate	±
<b>iii. Day 1 R/I gains/ Ins. losses</b>	±
<b>iv. Non-incremental acquisition costs</b>	-
<b>v. Interest expense from discounting unwind</b>	-

## Question 13 – Presentation

- (a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?
- (b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

- Most agree that the proposed summarized margin presentation would be useful to users.
- Respondents have requested that volume information (such as premiums and claims expenses) be presented on the statement of comprehensive income.
- Many believe that requirements to show single line for each portfolio will create too much detail (especially the case for large multi-line insurers).
- Outliers suggest that presentation of risk and residual margins separately may be more meaningful to users and that non-incremental adjustment expenses should be excluded from statement of comprehensive income as they are deemed unrelated to insurance contracts.

# Disclosure

- The ED has adopted the current IFRS disclosure principles for insurance and added more stringent requirements to ensure **alignment with the building blocks** model and consistency of minimal content in the notes.
  
- Aggregation is prohibited at a level greater than operating segment.
  
- There is great focus on two particular areas which have been expanded:
  - **Assumptions** and their changes:
    - Focus on the block estimation;
    - Assessment of the impact on profit and equity; and
    - Disclosure of changes from prior period.
  - **Reconciliation** of movements to balance sheet and income statement lines:
    - Specific minimum reconciling items set out;
    - Tailored requirements for the simplified method;
    - All amounts before and after reinsurance; and
    - Focussed on the cash flows exchanged and their comparison with estimates.

## Question 14 – Disclosures

- (a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?
- (b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?
- (c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

- Consensus is that most support disclosure principles proposed by the Board.
- Few responses outline the need for disclosures to be focused on information which is more meaningful to users of financial statements over the sheer volume of disclosures required.
- Should allow users to understand risks as opposed to provide them with all the information necessary to value the company.
- Some clarification has been requested with respect to the level desegregation for these disclosures.

## Transition and effective date

- The earliest that the new standard will be effective is for periods beginning on or after **January 1, 2013**.
- The effective date will move in parallel with IFRS 9.
- Early adoption will be permitted, although option may be limited by OSFI requirements.
- Same transitional provisions will apply for early adopters and existing IFRS reporting entities.
- FASB invitation to comment may generate more deliberation

### On transition:

- Insurance liabilities will be calculated as the sum of blocks 1 and 2 plus the risk adjustment (even if a composite margin approach is finally selected).
- All insurance intangible balances (e.g. deferred acquisition costs, intangibles arising from existing insurance contracts assumed in a previous business combination) will be **written off**.
- Profits on inforce contracts will be recognized at transition.
- All these adjustments will be recognised in opening retained earnings.

## Question 17 – Transition and effective date

- (a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?
- (b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?
- (c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?
- (d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

- Most disagree with transition requirements.
- While current proposal is more practical, comments suggest that retrospective application would be preferred over an adjustment to opening retained earnings (eliminate disconnect between pre-IFRS business and post).
- Comment letters discuss challenges with retrospective application. Suggest hybrid approach where estimation of initial residual margin is impracticable.
- Believe the effective date of proposal should be aligned with IFRS 9.
- Suggested dates for final IFRS to be effective range from no earlier than for reporting periods beginning on or after January 1, 2014 (some extend out to 2015).

## Keys to effective comments on an exposure draft

- Mandate of the IASB is to create standards that provide useful information to users of Financial Statements; users focus is on investors
- Criteria:
  - Faithfully represents the economics of the insurance contract
  - Provides information that helps investors make decisions
  - Consistency with existing / evolving IFRS accounting framework / objectives of the standard
- Need to substantiate all points – disagreeing without a proper rationale will not have much weight
- Comments based solely on implications (e.g. volatility, business impact, economic impact, etc.) will not be effective
- New standards are prepared on a cost-benefits approach – but always keep in mind that IASB will consider the need of the investors first and the need of preparers second
- Comments based solely on the difficulties to prepare information might be disregarded

# IFRS DEVELOPMENTS

## **IFRS Developments**

- Financial Instruments Project – IFRS 9
  
- Other changes in IFRS Standards
  - IFRS 1 - First-time Adoption of International Financial Reporting Standards
  
  - IAS 17 – Leases
  
  - IAS 19 – Employee Benefits
  
  - IAS 27 – Consolidated and Separate Financial Statements
  
  - IAS 28, 31 – Investments in Associates and Interest in Joint Ventures
  
  - IAS 37 – Provisions, Contingent Assets and Contingent Liabilities
  
  - Other projects
  
  - Regulatory Matters

# Financial Instruments Project

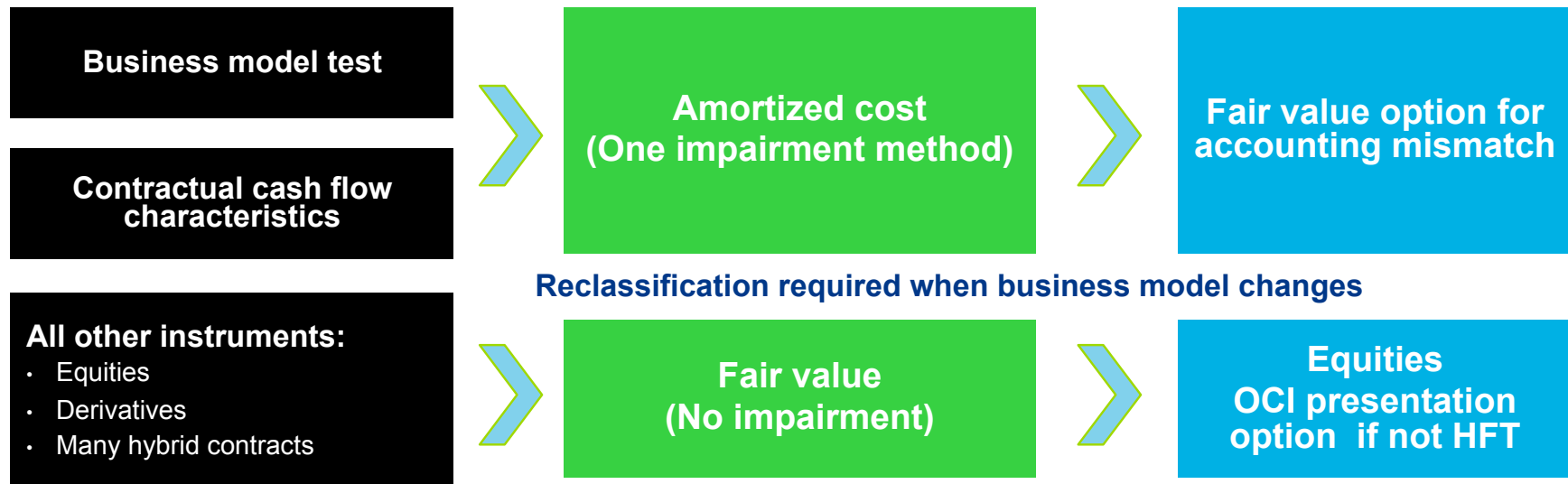
## IFRS 9 - Replacement of IAS 39 - 4 main phases

Phase	Status
Phase 1 – Classification and Measurement	<ul style="list-style-type: none"><li>• IFRS 9 <i>Financial Instruments</i> for financial assets was published in November 2009</li><li>• An exposure draft on the topic <i>Fair Value Option for Financial Liabilities</i> was published in May 2010 with a comment deadline of July 16, 2010</li></ul>
Phase 2 – Impairment Methodology	<ul style="list-style-type: none"><li>• The ED <i>Amortised Cost and Impairment</i> was published in November 2009 with a comment deadline of June 30, 2010</li><li>• Plan to issue a final standard in Q2 2011</li></ul>
Phase 3 – Hedge Accounting	<ul style="list-style-type: none"><li>• ED expected in Q3 2010</li><li>• Plan to issue a final standard in Q2 2011</li></ul>
Phase 4 – Asset and Liability Offsetting	<ul style="list-style-type: none"><li>• In June 2010, this fourth phase was added to the FI project</li><li>• ED expected in Q4 2010</li><li>• Plan to issue a final standard in Q2 2011</li></ul>

# IFRS 9 - Classification and Measurement

IFRS 9 is currently applicable only for financial assets, not financial liabilities

Only two main classification categories remain - amortized cost and fair value



## Debt Instruments: Amortized Cost Measurement Criteria

**Criterion 1:** Objective of entity's **business model** is to hold to collect contractual cash flows; and

**Criterion 2:** **Contractual terms** give rise on specified dates to cash flows that are solely payments of principal and interest (basic loan features) (IFRS 9.4.2)

- *Interest is consideration for time value of money and credit risk on the principal outstanding for the period*

### Fair value option

If amortized cost criteria are met then fair value option available if reduces a measurement mismatch

## Criterion 1: Business Model

Objective of entity's **business model** is to hold to collect contractual cash flows

- Can have multiple business models within a legal entity
- Not instrument by instrument – higher level of aggregation required for this assessment
- Not based on management's intent for an individual instrument (IFRS 9.B4.2)
- No requirement to hold to maturity and no tainting rules (IFRS 9.B4.3)

### Reclassifications

Change in business model – reclassification is required

## The FVTOCI Election:

Made on **instrument-by-instrument basis**

NOT for equities held for trading

Changes in fair value recognised through OCI except dividend income

### Dividends

Recognized as income  
per IAS 18

Not recognized as  
income if dividend  
represents return of  
investment (IFRS  
9.B5.12)

### F/X

FVTOCI equities are not  
monetary items per IAS  
21

Therefore, F/X element is  
recognized in OCI, not  
income (IFRS 9.B5.14)

## Transition - Initial Application Date

Retrospective application (IFRS 9, par. 8.2.1)

Business model test performed based on facts & circumstance at **date of initial application** (IFRS 9, par.8.2.4)

All previous “measurement mismatch” FVO elections for BOTH assets AND liabilities are revoked at **date of initial application** (IFRS 9, par. 8.2.8,9)

FVO (based on measurement mismatch) can be elected for all assets AND liabilities at **date of initial application** (i.e. measurement mismatch must exist at **date of initial application**) (IFRS 9, par. 8.2.7,9)

If impracticable to retrospectively apply the effective interest rate or impairment then FV at **date of initial application** becomes new amortized cost (IFRS 9, par. 8.2.10)

Designation at FVTOCI done at **date of initial application** based on facts & circumstances that exist at that date (IFRS 9, par. 8.2.7)

## Financial Liabilities Exposure Draft

Gains & losses on a financial liability designated as FVTPL presented as follows:

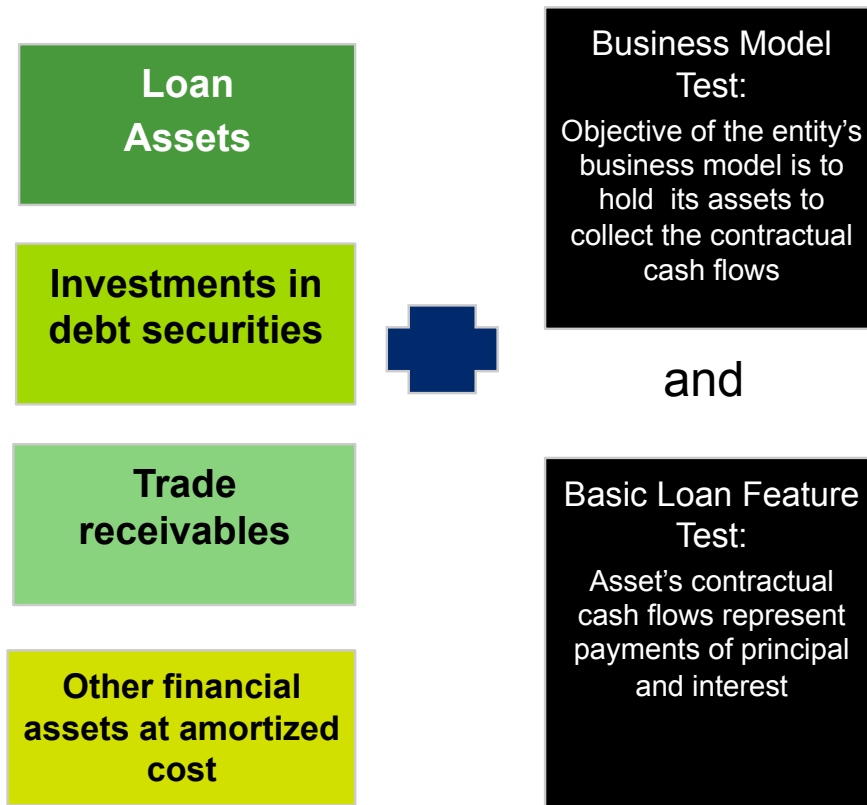
- Total change in P&L
- Reclassify change due to credit risk of the liability to OCI (with an offset to the P&L)

Amounts in OCI are not subsequently transferred to the P&L

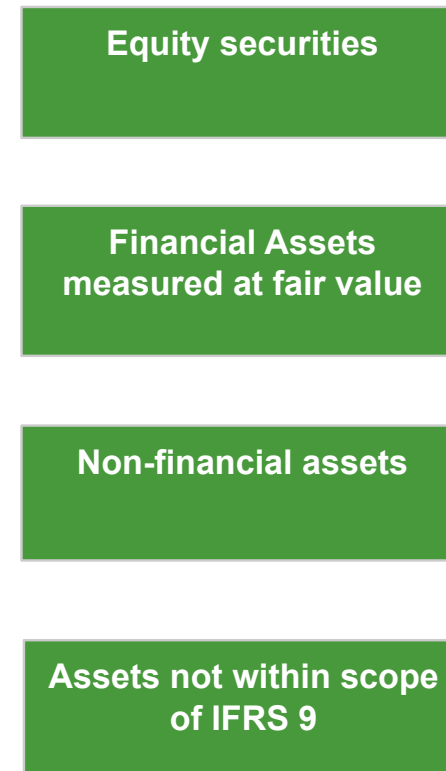
# Impairment Exposure Draft

## Proposed Scope:

### Instruments In Scope



### Instruments Not in Scope



# High-Level Overview



Asset by asset or groups of similar assets

Estimate expected cash flows taking into account expected future credit losses over the life of the asset

Probability-weighted possible outcome approach even if most likely outcome is full repayment

No initial loss is recognized immediately - estimate of future credit losses impacts net interest revenue over time

- Adjustment to the effective interest rate method (EIR)
- Margin deducted from EIR rate for estimate of future credit losses
- Applies to fixed rate, floating rate or combination rate financial assets carried at amortized cost
- Solve for effective interest rate that equates (1) the initial carrying amount with (2) the PV of expected future cash flows incorporating initially expected credit losses

- Margin for initially expected credit losses that is deducted from gross interest revenue in each period is set aside to gradually build-up an allowance for expected future credit losses
- Applies even if no actual losses have yet been incurred
- Does not require objective evidence of impairment or loss events to have occurred

- Each period, the entity must reassess the asset's expected cash flows, taking into account expected future cash flows
- Any changes in credit loss expectations – both favourable and unfavourable – are recognized immediately on a discounted cash flow basis as a gain or loss in earnings
- Discount revised expected future cash flows at asset's original EIR

## Existing Model vs. Proposed Model

Initial determination of the effective interest rate (EIR)	<ul style="list-style-type: none"> <li>- Based on initial net carrying amount and expected future cash flows ignoring future credit losses</li> </ul>	<ul style="list-style-type: none"> <li>- Based on initial net carrying amount and expected future cash flows that are adjusted for future credit losses</li> </ul>
Trigger for impairment	<ul style="list-style-type: none"> <li>- Trigger = objective evidence of impairment</li> </ul>	<ul style="list-style-type: none"> <li>- No trigger</li> </ul>
Measurement of revised carrying amount	<ul style="list-style-type: none"> <li>- Expected cash flows reflecting incurred losses discounted at original EIR</li> <li>- No fair value adjustments</li> <li>- No reflection of future credit losses</li> </ul>	<ul style="list-style-type: none"> <li>- Continually updated expected cash flows</li> <li>- Discounted at original EIR (fixed rate instruments) or combination of spot curve for benchmark rate and a spread (floating rate instruments)</li> <li>- No fair value adjustments</li> <li>- Reflects expected future credit losses</li> </ul>
Recognizing impairment	<ul style="list-style-type: none"> <li>- Profit or loss</li> </ul>	<ul style="list-style-type: none"> <li>- Profit or loss</li> </ul>
Subsequent impairments	<ul style="list-style-type: none"> <li>- If further losses have been incurred</li> </ul>	<ul style="list-style-type: none"> <li>- Recognized automatically through continual re-estimation of cash flows</li> </ul>
Revenue recognition after impairment	<ul style="list-style-type: none"> <li>- Based on EIR</li> <li>- Compatible with cost-based measurement objective</li> </ul>	<ul style="list-style-type: none"> <li>- Based on EIR</li> <li>- Compatible with cost-based measurement objective</li> </ul>
Reversals	<ul style="list-style-type: none"> <li>- Required if triggered by event after recognition of impairment loss</li> <li>- Limit to reversal up to amortized cost</li> </ul>	<ul style="list-style-type: none"> <li>- Automatically by adjusting the expected future cash flows (no trigger)</li> <li>- Upper limit is full contractual flows discounted at EIR</li> </ul>

## Example 1: Calculation of the Effective Interest Rate

Assume initial carrying amount of a loan is \$100,000

Loan contract promises one contractual payment of \$110,000 in exactly one year

Lender considers experience with portfolio of loans with similar credit risk conditions adjusted for current conditions

Based on above, lender expects to receive on average \$107,000 and expects to lose \$3,000 of the outstanding amount

The EIR in this example would be 7% versus the 10% coupon rate

## Example 1: Calculation of the Effective Interest Rate (continued)

Interest revenue accrued throughout the year is \$7,000. Entries during the year would be:

Dr. Interest receivable	\$10,000	
Cr. Interest revenue		\$7,000
Cr. Provision for expected credit losses		\$3,000

*Assuming that there were no changes in the entity's expectation of future credit losses over the year, there are three possible outcomes on maturity:*

- A** Credit losses exactly equal expectations - \$107,000 is collected. No additional profit or loss is recognized
- B** Credit losses are lower than expectations – assume the entire \$110,000 is collected. A gain of \$3,000 is recorded at the end of the year upon repayment of the loan to reflect the reversal of the provision
- C** Credit losses are higher than expectations – an amount less than \$107,000 is collected. An impairment loss is recognized to reflect the incremental losses

## Presentation and Disclosure

### – Statement of Comprehensive Income

Separate presentation of the following line items:

Gross interest revenue (calculated using EIR before expected losses taken into account)

Effect of allocating initially expected credit losses (the margin deducted from EIR)

Net interest revenue (credit adjusted interest revenue)

Gains and losses resulting from changes in loss expectations

Using Outcome B of  
Example 1 – No actual  
credit losses

\$ 10,000

(3,000)

\$ 7,000

\$ 3,000

## Presentation and Disclosure

### – Allowance Account and Write off Policy

Entities are required to use an allowance account to account for credit losses

Additional disclosures about financial assets measured at amortized cost:

- Reconciliation of changes in the allowance account – showing at a minimum

Increases due to allocation of initial expected credit losses (amount deducted from gross interest revenue)

Losses due to unfavourable changes in estimated credit losses

Gains due to favourable changes in estimated credit losses

Write offs

Entity's write off policy must be disclosed

## Presentation and Disclosure

### – Estimates and Changes in Estimates

Basis of inputs (e.g. internal historical data, rating reports, etc)

Estimating techniques used

Sensitivity analysis of inputs

- **reasonably positive alternative** inputs that would **significantly change** initial expected credit losses

Explanation of changes in estimates

- Cause of change
- New inputs and assumptions used

Change in estimation technique and reason for change

Disaggregation of gains and losses from changes in estimates

- Amount attributable to changes in estimate of credit losses
- Amount attributable to other factors (e.g. changes in estimates of prepayment rates)
- Comparison between development of the credit loss allowance over time and cumulative write-offs
  - If significant, a qualitative analysis of the effect of changes in credit loss estimates

## Effective Date and Transition

January 1, 2013 or later

Early adoption would be permitted, subject to OSFI approval

On transition, adjust the effective interest rate on financial assets measured at amortized cost to approximate the rate that the entity would have determined at inception by using an expected loss approach

# **OTHER CHANGES IN IFRS STANDARDS**

## Amendments to IFRS 1 - First-time Adoption of International Financial Reporting Standards

- Exposure Draft was issued in August 2010
- The ED proposes to:
  - Amend the date of prospective application of the de-recognition of financial assets and liabilities from “January 1, 2004” to “the date of transition of IFRSs” (IFRS 1.B2)
    - IAS 39 de-recognition requirements can be applied prospectively
  - Amend the date of the option to apply the requirement to fair value financial assets and liabilities prospectively to transactions entered into “on or after the date of transition to IFRSs” (IFRS 1.D20)
    - Relieve first-time adopters from recalculating ‘day 1’ gains / losses on transactions occurring before the transition date
- Comment period ended on October 27, 2010

# Amendments to IAS 17 for Leases

Exposure Draft issued in August 2010. Comment period to close on December 15, 2010

Primary current standard – IAS 17

- Guidance addresses the accounting for both lessees and lessors
- Scope includes leases of property, plant and equipment as well as of intangible assets; concessionary arrangements
- Accounting for a lease depends on its classification as either an operating or finance (i.e., capital) lease; operating leases are “off balance sheet” while finance leases are “on balance sheet”
- If a lease transfers “substantially all” the risks and rewards of ownership, it is classified as a finance lease
- Operating lease payments are usually recognized on a straight-line basis

## Amendments to IAS 17 for Leases

Key elements of the exposure draft are:

- Requires lessees to recognize assets and liabilities for all leases thus eliminating operating lease accounting.
- Contingent rentals and renewal options would need to be estimated and these estimates would need to be reassessed in the future.
- Lease expense would be composed of interest and amortization expense and would be recognized earlier in the lease term.
- Lessors would apply one of two models depending on whether significant risks or benefits of the underlying asset are transferred to the lessee.
- The lessor models could have a significant financial statement affect, including increasing assets and liabilities recognized and limiting the recognition of up-front profit.
- The proposals could also affect the structuring of lease contracts, performance metrics used, debt covenants, accounting policies, and information systems.
- A final standard is expected to be issued in June 2011

## Amendments to IAS 17 for Leases

### Key considerations:

- Determining the classification of leases may require increased judgment because there are no strict classification criteria
- Processes and controls for classifying leases may need to be enhanced
- Data capture for leases may be more detailed, which could lead to the need for information system changes
- Changes in lease classification may affect income taxes or financing ratios (i.e., debt to equity)

## Amendments to IAS 19 for Employee Benefits

### Primary standard – IAS 19

- Guidance addresses short-term benefits; post employment benefits, (i.e., pensions); other long-term benefits (i.e., bonuses); and termination benefits
- Accounting for post-employment benefits depends on the type of plan (defined contribution, defined benefit or a multi-employer plan)
- Defined contribution plans involve payment of fixed amounts that are expensed as the employee provides services
- For defined benefit plans, a benefit obligation is recognized using an actuarial valuation method, net of plan assets held
- Termination benefits are recognized when “demonstrably committed”

## Amendments to IAS 19 for Employee Benefits

### Key elements of exposure draft

- The option to defer and amortize actuarial gains and losses over a future period would be eliminated and all actuarial gains and losses would be required to be recognized immediately through other comprehensive income
- The full amount of the overfunded or underfunded status of the defined benefit plans would be recognized
- The proposals would affect other aspects of pension accounting, including recognition of the actual return on plan assets and service costs.
- Disclosure requirements would increase significantly
- A final standard is expected to be issued in 2011
- The IASB is also working on a project to clarify certain aspects in IAS 19 around termination benefits.

## Amendments to IAS 19 for Employee Benefits

### Key considerations

- Current plans will need to be evaluated to ensure they are accounted for under the appropriate type of plan
- Processes and controls for the asset ceiling test will need to be developed
- Data capture may be more detailed, which could lead to the need for information system changes
- Changes in the timing and amount of pension cost may affect on income taxes

# Amendments to IAS 27 for Consolidated and Separate Financial Statements

## Primary standard – IAS 27

- Key issue is determining whether “control” exists; control is defined by IAS 27 as the power to govern the financial and operating policies of an entity so as to obtain benefit from its activities
- Guidance provides a number of control “indicators” that focus on governance and decision-making activities, as well as economic factors such as benefits and risks
- Potential voting rights must be considered when assessing whether control exists
- Entities holding less than majority of voting rights may still consolidate under “de facto” control
- Guidance also included on the presentation of the parent’s separate financial statements
- This is a joint project with the FASB
- Project has two parts:
  - Part I – Consolidation and Disclosure
  - Part II – Investment Entities
- New standard regarding Part I expected to be issued shortly
- Exposure Draft on Part II issued

# Amendments to IAS 27 for Consolidated and Separate Financial Statements

Key element of the new standard are:

- Definition of control
  - A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity. A reporting entity has the power to direct the activities of another entity when it has the ability to enforce its will in making decisions about the activities of an entity that significantly affect the returns at the time that decisions need to be taken.
- Disclosures

A reporting entity should disclose information that helps users of financial statements to understand:
- the significant judgements and assumptions (and changes to those judgements and assumptions) made by the reporting entity in determining whether it controls (or does not control) another entity and/or the reporting entity's involvement with structured entities;
- the interest that the non-controlling interests have in the group's activities;
- the effect of restrictions on the reporting entity's ability to access and use assets or settle liabilities of consolidated entities, as a result of where the assets or liabilities are held in the group;
- the nature of, and changes in, the risks associated with the reporting entity's control of consolidated structured entities or involvement with unconsolidated structured entities.

# Amendments to IAS 27 for Consolidated and Separate Financial Statements

Key considerations:

- Determining whether entities should be consolidated may require increased judgment
- Processes and controls should be developed for monitoring potential voting rights and whether they are currently exercisable or convertible
- Processes for the capture of financial data related to all controlled entities should be developed, and accounting policies and reporting dates should be conformed
- Changes in the reporting entity as a result of more or fewer entities consolidated may affect income taxes

## Amendments to IAS 28 and 31 for Investments In Associates and Interests in Joint Ventures

Primary standards – IAS 28 and 31

- Key issue is determining whether “significant influence” exists
- Significant influence is the power to participate in financial and operating policy decisions of the entity
- Entities where significant influence exists are considered to be “associates” and are accounted for using the “equity method”
- Investment in an associate is initially recognized at cost; subsequent carrying amount is increased or decreased based on investor’s share of profit/loss of associate; distributions reduce the carrying amount
- There are scope exceptions for “investment” companies and investments “held for sale”
- Joint control exists when the financial and operating policy decisions require the consent of all ventures through the contractual sharing of control
- Investments in jointly controlled entities may be accounted for under either the equity method of accounting or the “proportional consolidation” method; the proportionate consolidation method is expected to be eliminated

# Amendments to IAS 28 and 31 for Investments In Associates and Interests in Joint Ventures

Key element of the new standard are:

## Joint Control

- The final IFRS will maintain the term 'joint control' as one of the features that, along with the existence of an agreement, defines 'joint arrangements'.

## Types of joint arrangement

- Joint arrangements will be classified in two types, 'joint operations' and 'joint ventures'. Each type of joint arrangement is aligned with a specific accounting requirement (ie accounting for assets, liabilities, revenues and expenses in the case of a joint operation, and accounting for an investment using the equity method in the case of a joint venture).
- When joint arrangements are established in a separate entity, it will be necessary to consider all relevant facts and circumstances to assess whether the arrangement is a joint operation or a joint venture, including the structure and form of the arrangement and the contractual terms agreed by the parties.

## Investors in a joint arrangement

- The final IFRS will introduce the term 'investors in a joint arrangement' to designate a party to a joint arrangement that does not have joint control over the activity of that joint arrangement.

## Consensus of SIC-13

- The consensus of SIC-13 Jointly Controlled Entities—Non-Monetary Contributions by Venturers will be incorporated as an amendment to IAS 28 Investments in Associates.

# Amendments to IAS 28 and 31 for Investments In Associates and Interests in Joint Ventures

## Disclosures

- The disclosure requirements for joint arrangements will be placed in a separate IFRS. The main disclosure requirements affecting both joint arrangements and associates will be:
  - a) a list and description of interests in individually-material joint arrangements and associates;
  - b) disclosure of commitments in relation to an entity's interests in joint ventures and contingent liabilities in relation to an entity's interests in joint ventures and associates; and
  - c) summarised financial information will be provided for individually-material joint ventures and associates.

## Transition

- The final IFRS will not require an entity to adjust the differences between the proportionate consolidation method and the equity method retrospectively
- An entity will be required to apply paragraphs 31-34 of IAS 28 with regard to impairment losses to the opening balance of the investment, and to recognise any related impairment in retained earnings at the opening balance of the earliest period presented.
- An entity will be required to disclose a breakdown of the assets and liabilities that have been aggregated into the single line investment balance at the opening balance of the earliest period presented

# Amendments to IAS 28 and 31 for Investments In Associates and Interests in Joint Ventures

## Key Considerations

- Determining whether entities should be considered associates will require increased judgment
- Processes and controls should be developed for monitoring potential voting rights and whether they are currently exercisable or convertible
- Processes for the capture of financial data for all entities being accounted for as associates should be developed, and accounting policies and reporting dates should be conformed
- Changes in the reporting entity as a result of more or fewer entities being accounted for as associates may affect income taxes

## Amendments to IAS 37 for Provisions , Contingent Liabilities and Contingent Assets

- The IASB is currently working on a project to amend the guidance in IAS 37 and issued exposure drafts in June 2005 and January 2010. A third exposure draft is expected to be issued in 2011.

### Primary standard – IAS 37

- Guidance addresses the accounting for “provisions” and “contingent” assets and liabilities
- Provisions are liabilities of uncertain timing or amount are “probable” (i.e., more likely than not) of occurring and resulting in an outflow of resources to settle the obligation (may be either legal or constructive)
- Provisions are measured using a settlement notion use of the “best estimate” or mid-point of range if all possible outcomes equally likely
- Discounting of provisions is required, if material
- Several disclosures are required, although “prejudicial” items are not required to be disclosed

## Amendments to IAS 37 for Provisions , Contingent Liabilities and Contingent Assets

- Under the exposure draft, the criteria for determining when a liability should be recognized would change such that all obligations that meet the definition of a liability would be recognized unless they are unable to be measured reliably.
- Uncertainties related to the outcome would be incorporated into the measurement of the liability.
- This is in contrast to the current approach where uncertainties to the outcome affect whether an item is recognized – as a provision – or disclosed – as a contingent liability.
- The comment letters received on the exposure drafts were largely negative, causing the IASB to perform additional outreach activities to further understand constituent concerns. The IASB is moving forward with the project but has indicated that it will rethink certain aspects of the proposals.

# Amendments to IAS 37 for Provisions , Contingent Liabilities and Contingent Assets

Key considerations:

- Determining liability recognition and corresponding disclosures may require increased judgment
- The legal department and outside counsel may need to be educated on the threshold for recognition of provisions
- Processes and data capture for provisions may be more detailed, which could lead to the need for information system changes
- Changes in the timing and measurement of provisions may affect income taxes

**OTHER PROJECTS**

## Other projects

- Revenue Recognition
- Liabilities – IAS 37 Amendments
- Financial Statement Presentation
  - Replacement of IAS 1 and IAS 7
  - Presentation of OCI

# REGULATORY MATTERS

# Changes to OSFI Guidelines

## Overview:

- Minimum Capital Test
- Changes required to align with IFRS (terminology and some guidance)
- Changes made in 2 phases:
  - Phase 1: Core guidelines
    - Drafts issued in April 2010; comments were due by June 15, 2010
  - Phase 2: Consequential guidelines – changes made in July

## MINIMUM CAPITAL TEST (MCT)

Draft Capital Guidelines issued November 2010

- This guideline outlines the capital framework, using a risk-based formula for minimum capital required, and defines the capital that is available to meet the minimum standard. The MCT determines the minimum capital required and not necessarily the optimum capital required.
- Similar framework to MCCSR used for Life Insurance Companies (ratio determined is a function of capital available and capital required)
- OSFI expects each institution to establish a target capital level, and maintain ongoing capital, at no less than the supervisory target of 150% MCT
- Property and Casualty insurers are required to engage the auditor appointed pursuant to section 337 of the *Insurance Companies Act* to report on the MCT in accordance with CICA Handbook Section 5025 *Standards for Assurance Engagements*.
- The auditors should opine on whether the MCT has been prepared, in all material respects, in accordance with the provisions of this Guideline (new requirement for 2011).
- Guideline is expected to be updated for reference to Section 5025 (which will be superseded by IFRS) and format of new audit opinions under Canadian Assurance Standards.

## Changes to OSFI Guidelines (continued)

Phase 1 – changes made to the following:

- C-1: Impairment of Financial Instruments at Amortized Cost
- D1-A & D1-B: Annual Disclosures
- D-5: Structured Settlements
- D-10: Fair Value Option

Phase 2 – changes made to the following:

- D-6: Derivatives Disclosure
- D-9: Source of Earnings Disclosure (Life Insurance Companies)
- E-12: Inter-Segment Notes for Life Insurance Companies

## Changes to OSFI Guidelines (continued)

Rescinded the following:

- D-3: Accounting for NHA Mortgage Backed Securities
- D-4: Transfers of Receivables with Recourse
- D-7: Accounting for Reinsurance of Short-Term Insurance Contracts by P&C Insurance Enterprises
- D-8: Accounting for Transfers of Receivables including Securitizations

Link:

- [http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/accounting/guidelines/loans/ifrs\\_omni\\_gias\\_e.pdf](http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/accounting/guidelines/loans/ifrs_omni_gias_e.pdf)

# Annual Returns

## LIFE-1 / LIFE-2 Returns

- Updated 2010 annual and 2011 interim returns on OSFI's website:  
[http://www.osfi-bsif.gc.ca/osfi/index\\_e.aspx?DetailID=677](http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=677)  
[http://www.osfi-bsif.gc.ca/osfi/index\\_e.aspx?DetailID=679](http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=679)

- Fraternal

- The current fraternal annual return will be eliminated effective December 31, 2011
- LIFE-1 or LIFE-2 annual returns to be used
- Quarterly filings required effective Q1 2012

- P&C-1 / P&C-2 Returns

- Updated 2010 annual and 2011 interim returns on OSFI's website:  
[http://www.osfi-bsif.gc.ca/osfi/index\\_e.aspx?DetailID=671](http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=671)  
[http://www.osfi-bsif.gc.ca/osfi/index\\_e.aspx?DetailID=675](http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?DetailID=675)

## Other Guidance

### Draft Guideline A-4: Capital Targets – Federally Regulated Insurance Companies

- Comment period has ended (August 31, 2010)

[http://www.osfi-bsif.gc.ca/osfi/index\\_e.aspx?ArticleID=3706](http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=3706)

### Draft Guideline B-3: Sound Reinsurance Practices and Procedures

- Comments due by October 1, 2010

[http://www.osfi-bsif.gc.ca/osfi/index\\_e.aspx?ArticleID=3887](http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=3887)

## Other Guidance (continued)

### Draft Guidance for Reinsurance Security Arrangements

- Comments due by October 1, 2010

[http://www.osfi-bsif.gc.ca/osfi/index\\_e.aspx?ArticleID=3891](http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=3891)

- Regulation and Supervision of Reinsurance

- Paper

[http://www.osfi-bsif.gc.ca/osfi/index\\_e.aspx?ArticleID=3626](http://www.osfi-bsif.gc.ca/osfi/index_e.aspx?ArticleID=3626)

**Deloitte.**