International Accounting Standards

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Speakers:
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Publicly owned U.S. insurance companies, like companies in any other type of business, report to the SEC using GAAP. They report to insurance regulators and the Internal Revenue Service using SAP.

Accounting principles and practices outside the U.S. differ from both GAAP and SAP. But this may change. In 2001 the International Accounting Standards Board (IASB), an independent international accounting standards setting organization based in London, began work on a set of global accounting standards, International Financial Reporting Standards (IFRS).

Ideally, a universal set of accounting principles, IFRS, would facilitate global capital flows and lower the cost of raising capital.
IFRS

Who? IASB, FASB and SEC

What? IFRS is a single set of accounting standards that is rapidly gaining worldwide acceptance

Why? Global Comparability of Information, Efficiencies in Financial Reporting

When? Sooner than one might think

How? It depends who you ask!
IFRS - Key Players

IASB - International Accounting Standards Board
Standards are promulgated by the London-based board

FASB - Financial Accounting Standards Board
FASB is working with IASB to converge standards

SEC - Securities and Exchange Commission
The SEC regulates the use of IFRS for US Public entities
**IFRS - Key Players**

- **IASB** International Accounting Standards Board which issues:
- **IAS** International Accounting Standards – before 2001

- **IFRIC** International Financial Reporting Interpretations Committee which issues:
- **IFRICs** Interpretations of the IFRS – after 2001
- **SICs** Standing Interpretations Committee – before 2001
**IFRS**

**History**

- **1996**: Initiative from SEC to move towards single set of reporting standards, no significant progress until after 2000
- **2001**: Formation of IASC Foundation and IASB
- **2002**: IASB and FASB announce initiative to achieve compatibility in financial reporting standards
- **2003**: EU endorses use of IFRS
- **2005**: Europe – 7,000 businesses in 25 countries switch to IFRS***
- **2006**: IASB and FASB agree on roadmap for GAAP/IFRS convergence
- **2007**: Brazil, Canada and Japan establish timelines to adopt; US SEC removes reconciliation requirement for non US countries reporting under IFRS; Israel, Malaysia and Mexico to adopt IFRS; SEC publishes roadmap for IFRS adoption
- **2009**: SEC Roadmap comments received

***12,000 companies in 100 countries currently use IFRS
On August 27, 2008, the SEC issued a proposed “Roadmap” for US issuers to transition to reporting under IFRS. Proposed timeline under the SEC Roadmap is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Event Description</th>
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<tbody>
<tr>
<td>2009</td>
<td>Comment Period Deadline for Roadmap</td>
</tr>
<tr>
<td>2010</td>
<td>Early Adopters – Top 20 by Market Capitalization</td>
</tr>
<tr>
<td>2011</td>
<td>SEC Votes on Adoption</td>
</tr>
<tr>
<td>2012</td>
<td>Effective Conversion Start (if adopted)</td>
</tr>
<tr>
<td>2013</td>
<td>Large Accelerated Filers</td>
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<tr>
<td>2014</td>
<td>Accelerated Filers</td>
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<tr>
<td>2015</td>
<td>Remaining Smaller Companies</td>
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**IFRS - Characteristics**

Principles based (IFRS) vs. Rules based (GAAP)

IASB Framework:
- Establishes the thread of the Standards
- Based on definition & recognition criteria of accounts

Compliance with IFRS includes:
- Standards - 41 IASs, 29 in effect, and 8 IFRSs
- Interpretations - 33 SICs, 11 in effect, and 18 IFRICs

IAS Hierarchy in order to interpret guidance

Alternative accounting treatments increasingly being eliminated

Regulators enforce compliance, not IASB
Current IFRS

Current Relevant Guidance for Insurance Companies:

- IAS 18  Revenue Recognition
- IAS 37  Provisions
- IAS 39  Financial Instruments
- SIC-12  Consolidation – Special Purpose Entities
- IFRS 1  First Time Adoption of IFRS
- IFRS 4  Insurance Contracts
- IFRS 7  Financial Instruments: Disclosures
Principles based (IFRS) vs. Rules based (GAAP)

Principles based standards:
- Developed from conceptual framework
- Management required to apply judgment/expertise
- Spirit of the standard
- Economic reality and substance of the transaction

Rules based standards:
- Strict rules that must be adhered to
- Some choices on presenting the transaction
- May structure transaction to comply with rules
- Complex and detailed
**IFRS – Open Items**

**Open Items**

- Specified Transition Date
- IFRS Lacks Detailed Rules
- Standard Setting is responsibility of non-US organization
- Protecting U.S. Interests
- Convergence or Adoption
### IFRS – Open Items

**Open Items**

<table>
<thead>
<tr>
<th>Agreement on Key Principles</th>
<th>IFRS Due Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Revenue Recognition</td>
<td>2011</td>
</tr>
<tr>
<td>• Insurance Contract</td>
<td>2011</td>
</tr>
<tr>
<td>• Financial Instruments (IAS 39 replacement)</td>
<td>2010</td>
</tr>
<tr>
<td>• Financial Statement Presentation</td>
<td>2011</td>
</tr>
<tr>
<td>• Liabilities (IAS 37 amendment)</td>
<td>Q4 2009</td>
</tr>
<tr>
<td>• Leases</td>
<td>2011</td>
</tr>
<tr>
<td>• Post Employment Benefits (incl. Pension)</td>
<td>2011</td>
</tr>
<tr>
<td>• Income taxes</td>
<td>2010</td>
</tr>
<tr>
<td>• Financial Instruments with characteristics of equity</td>
<td>2011</td>
</tr>
</tbody>
</table>
IFRS 1 – First Time Adoption of IFRS

Public companies - to report 3 years comparative at 12/31/14, the change will require re-statement of all prior years in order to get beginning balance at 01/01/12—2 sets of books!
**IFRS**

**Significant differences between IFRS and US GAAP**

- **Consistency of Accounting Policies** – required for similar transactions
- **Consolidation** – based on control, off-balance sheet items now on balance sheet
- **Income Taxes** – No valuation allowance, Timing of measurement
- **Impairment** – No 2-step test, reversals allowed
- **Disclosures** more substantial under IFRS
  - Disclosure of management compensation
**IFRS**

**Significant differences between IFRS and US GAAP (cont.)**

Revenue Recognition -  
  Limited guidance in IAS 18  
  GAAP guidance highly detailed, industry specific  
  IFRS may reduce revenues for some

Provisions –  
  Discounting required  
  Self-insured liabilities may be affected  
  May have liabilities under IFRS & not GAAP

Financial Instruments classified as liabilities – principles-based definitions of liabilities and equity
IFRS 4 – Phase I

Insurance Contracts Project Started in 1997

IFRS 4 – Phase I – Limited improvements to current accounting; interim standard

IFRS 4 – Phase II – Redefines measurement of insurance liabilities (fair value)

Applies to both insurance and reinsurance contracts

Does not apply to other assets and liabilities of an insurer

Move away from the deferral and matching (P & L) approach

Move to an asset and liability approach (Balance Sheet)
IFRS 4 - Phase I

- Interim Standard – focuses primarily on disclosures and classification of insurance contracts

- Introduces a definition for an insurance contract based on significant insurance risk

- Exempts insurers from changing their accounting policies to comply with IFRS Hierarchy to limited required changes to existing accounting practices for insurance contracts and extensive disclosures

- Refers back to local GAAP in Phase I for items not yet determined
Insurance Contract –

“a contract under which one party (the insurer) accepts significant insurance risk for the other party (the holder of the policy), agreeing to compensate the policyholder if an event occurs uncertain future (the insured event) that affects adversely on the policyholder insurance”

Excludes Financial Risk

No quantitative guidance for assessing the significance of insurance risk

- Probability
- Magnitude

- Issues addressed in the DP:
  - Current Exit Value approach (CEV)
  - Single approach for life and non-life insurance contracts
  - Risk Margin Assumptions
  - No locking of assumptions/”Unlocking”
  - Discount rate
  - Incorporating assumptions of premiums based on guaranteed insurability
  - Estimating cash flows based on market participant view
  - Possibility of recognition of gains and losses at inception
  - Use of entity’s own credit standing
  - Acquisition costs to be expensed, no deferral allowed
CEV Model Building Blocks

1. **Cash Flows**
   - Explicit, unbiased, market-consistent, probability weighted and current estimates of the contractual cash flows

2. **Discounting**
   - Current market discount rates that adjust the estimated cash flows for the time value of money

3. **Risk and Service Margins**
   - An explicit and unbiased estimate of the margin that market participants require for:
     - Bearing risk (a risk margin); and
     - Providing other services (a service margin)
Recent discussions (July 23, 2009 meeting) and current challenges:

- IASB not conclusive on issues
- Will reserves be valued at Current Fulfillment Value (CFV) or Current Exit Value (CEV)?
- Differences exist between IASB and FASB, for example, IASB and FASB both in favor of CFV but currently debating certain points:
  - **FASB** – Service margin is already factored into liability estimate included in PV Cash flow and premium determination. Risk margin is a exit value concept and not CFV
  - **IASB** – Risk margin needs to be included or you are not accounting for expected variability
  - **FASB**: DFV is entity specific and does not require market participant views
  - **IASB**: More in favor of a modified IAS 37 approach that includes elements of market participants views.
Comparison of Current Fulfillment Value (CFV) with CEV

- **CFV** = “the present value of all expected cash flows that the insurer anticipates over the life of the contract, taking into account the most relevant and reliable available market and entity specific information”

- **CFV** would use **entity specific** cash flow estimates for factors not observable in the market (e.g. expense rates) and market consistent estimates for factors observable in the market (e.g. interest rates)

- **CFV** would not consider entity’s credit characteristics

- **CFV** criticized for the use of entity specific information and lack of clarity over principle of risk margin in CFV model
IFRS 4 - Phase II: Recent Discussions

Other items under discussion:

- If you include a risk margin is it adjusted each reporting period?
- If you have reserve development does it go against risk margin first and then to P&L?
- How should positive cash flow be brought into earnings?
- Should Cash flow and presentation be gross or net?
**IFRS 4 - Phase II: Recent Discussions**

- Unearned premium model - could be used for short duration contracts

- Policy holder behavior and contract boundaries - “Look through approach” – i.e. treat cash flows subject to renewal and cancellation as part cash flows

- Revenue recognition - link between the revenue recognition project and the insurance contract project is not clear

- Field test - aim is to target 15 insurers for field test
IFRS 4 - Phase II: Current Challenges

Policy Acquisition Costs:
- Consensus that it should be expensed upfront
- More unanswered questions:
  - Should you allow income recognition upfront to offset expense?
  - Should it be considered in the PV Cashflow?
  - Rights for future annual premiums?

Revenue Recognition Discussion Paper:
- Onerous contracts – Insurance policies fall into this definition
- Revenue DP says you determine on a contract by contract basis. FAS 60 currently allows for determination by line of business.
- Emphasis on one revenue recognition standard could eliminate Insurance specific standard. Why is insurance any different than other industries?
IFRS 4 - Phase II: Current Challenges

IAS 37, Liabilities

- Need to align the insurance contract project with the IAS 37 amendment project
- Insurance liabilities should be measured based on the amount that the insurer shall rationally pay to relieve the liability. The margin should be calibrated such that there is no one day loss or gain.
**IFRS - Impact of Changes**

- Rating Agencies – Currently most rating agencies support the change to IFRS
- Regulators
  - NAIC – would need to adjust IRIS and RBC measurement tools to ensure measures are fair to IFRS and US GAAP reporting entities.
  - NAIC – will Statutory standards be adjusted to mirror IFRS?
  - SEC – Prefer change - Need for consistent reporting across industries and geography
  - IRS – If NAIC adopts changes to NAIC annual statement will IRS Forms follow suite or will we need to reconcile back to IRS format?
- Reduces the comparability of financial statements among companies:
  - Measurement could be overly subjective.
  - Reduces transparency.
- Introduces undue volatility into the financial statements
IFRS - Impact of Changes

• Systems and Controls
  • IT systems will need to be changed to allow necessary data to be captured and processed
  • Companies will need to implement new controls to ensure they can meet the requirements of the IFRS standards
• Auditing Standards on Internal Control
  – Sox and non-public Auditing Standards are still relevant
  – Will place additional emphasis on transition process of transition to IFRS
• Convergence Vs. Adoption
  – Convergence of GAAP toward IFRS over time may allow changes to be implemented prospectively
  – Adoption of IFRS would require restatement of all years presented
  – Balancing benefit of consistence with cost of implementation
• Staff training on IFRS
• Performance evaluations and incentive plans
• Costly to implement
**IFRS - Impact of Changes**

- Aspects Affecting Captives
  - Capital requirements – Letters of Credit and other alternative forms of capital may not meet IFRS requirements
  - Financial statement format – Should regulators currently allowing GAAP Statements allow IFRS?
  - Consolidation –
    - Will captive transactions with Parent be eliminated in consolidation?
    - What if there is a fronting company involved?
  - Captives with investments in affiliates should consider impact of
    - Consolidation standards - Equity method vs consolidation
    - Revenue recognition standards – will royalty arrangements or other sale and lease back transactions be effected
Solvency II

Solvency II (SII)

The aim of EU solvency rules is to ensure that insurance undertakings are financially sound and can withstand adverse events, in order to protect policyholders and the stability of the financial system as a whole.

SII rules stipulate minimum amounts of financial resources for insurers.

SII will introduce economic risk-based solvency requirements in EU, more sophisticated than in the past.
Solvency II

Solvency II (cont)

Framework will consist of three main ‘pillars’ of regulation

Pillar 1 consists of the quantitative requirements – how much?

Pillar 2 requirements for the governance, risk management and supervision of insurers,

Pillar 3 is on supervisory reporting and transparency requirements.
**Solvency II**

IFRS on Insurance and SII differences:

<table>
<thead>
<tr>
<th>IFRS:</th>
<th>applies to insurance contracts</th>
</tr>
</thead>
<tbody>
<tr>
<td>SII:</td>
<td>applies to &quot;regulated products&quot; (may not be insurance contracts)</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>IFRS:</th>
<th>Risk margin to be based on market consistent principles</th>
</tr>
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<tbody>
<tr>
<td>SII:</td>
<td>Risk margin is based on cost of capital approach</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>IFRS:</th>
<th>Takes future cash flows only if certain conditions are met</th>
</tr>
</thead>
<tbody>
<tr>
<td>SII:</td>
<td>Takes all cash flows in a contract, e.g a 25 year contract</td>
</tr>
</tbody>
</table>

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<thead>
<tr>
<th>IFRS:</th>
<th>Discounting basis is the risk free rate as per the DP</th>
</tr>
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<tbody>
<tr>
<td>SII:</td>
<td>Use of swap rate (market rate should be calculated to match the currency, duration and liquidity of the cash flows)</td>
</tr>
</tbody>
</table>
**IFRS - Challenges**

New challenge for consistency of Fair Value definition under:

- IFRS,
- US GAAP,
- European Solvency II,
- Economic Capital,
- Principles Based Reserving!!!!