

Ready or not, here it comes?

Status of IASB re-deliberations on the IFRS for insurance contracts and where we go from here

October 2014



With the new IFRS insurance contract standard moving towards finalisation, now is the time to begin preparing implementation plans. How will the new IFRS affect valuations, reported earnings and investor relations? How will it interact with other developments including Solvency II for European insurers and how can companies make sure the transition is as smooth and cost-efficient as possible?

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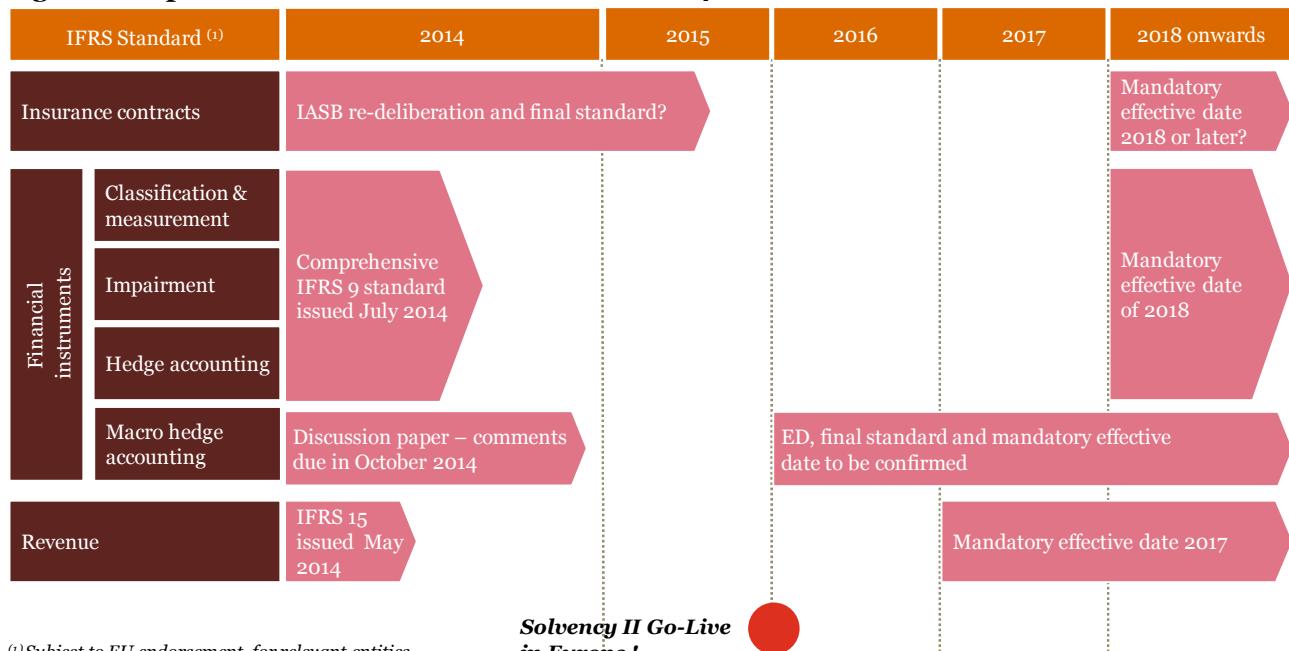
Moving towards the end game

“Ready or not, here it comes?” summarises the status of the International Accounting Standards Board (IASB) re-deliberations on the IFRS for insurance contracts and where we go from here.

After many years of preparation and consultation, the International Financial Reporting Standard (IFRS) for insurance contracts (IFRS 4 Phase II) appears to be finally entering the end game. Significant topics that are still to be finalised are the treatment of participating contracts and the arrangements for transition from the existing reporting requirements (IFRS 4). We and others continue to engage with the IASB on these topics. During 2014, the IASB has spent a substantial amount of time during its re-deliberations on the approach for participating contracts including considering an alternative approach developed by the European industry. As we go to press, no conclusions have been reached for participating contracts and a number of alternatives are still open to the IASB. The indications are that the IASB is gearing up to publish a finalised IFRS standard in 2015. This will represent for many organisations the beginning of a significant undertaking. Given the potential significance of the change for participating contracts compared to current accounting, the provision of a review draft by the IASB would allow companies to undertake further field testing of the final proposals.

Disappointingly, one of the project’s initial objectives, a single globally converged standard for insurance contracts, will not be achieved as the US accounting standards setter (the Financial Accounting Standards Board - FASB) is now only focusing on identifying targeted improvements to US GAAP for long duration insurance contracts and disclosure enhancements for short duration contracts. There will therefore not be a single globally converged standard for insurance contracts.

Figure 1: Expected IFRS timeline as at October 2014



Source: PwC analysis of latest IASB proposals

The IASB is expected to allow around three years between the publication and effective date to give both insurers and the markets time to prepare and adjust. If the final standard is issued in the first half of 2015, an effective date of 2018 is possible. If it is issued later then the effective date may move to 2019. This might seem like a relatively relaxed timetable, but in reality it is not. There are also plenty of other changes that would appear more pressing, including Solvency II for insurers with operations in Europe. However, it's vital to get strategic planning for IFRS 4 Phase II underway as soon as possible. Preparing an opening balance sheet for restated comparatives in 2017 (or 2016 for SEC reporters) will be the initial focus. Together with IFRS 9 and 15,

this forms a package of changes for insurers to consider. With many of the necessary systems likely to take 18 months to two years to design, install and embed, this is going to be a busy time.

Making the most of the time between now and the effective date, given conflicting priorities, will be an important consideration in ensuring a successful transition to IFRS 4 Phase II. Early evaluation and planning will make it easier to align the data collection, modelling and reporting systems with those already being developed for Solvency II in Europe and other developing regimes globally. The importance of looking at reporting developments together is heightened by the coming changes to financial instrument accounting (IFRS 9) and revenue accounting (IFRS 15) for non-insurance contracts (see Figure 1). IFRS 9, in particular, will have close linkage with the new insurance contract standard.

Beyond the need to ensure efficient transition is the impact on how the business is judged by analysts and investors. The intensity with which the markets are already pressing insurers to reveal and explain their Solvency II numbers in Europe suggests that they may not wait until IFRS 4 Phase II goes live and will be pressing companies for earnings impact indications.

The remainder of this paper examines:

- What to expect under the new insurance contracts standard and what has changed since the second exposure draft was published by the IASB in 2013.
- The issues that are still to be resolved in relation to participating contracts.
- The interactions with other regulatory and reporting changes.
- The implementation demands these developments present and how companies can put themselves in the best position to deal with the race ahead.

We have also included a variety of useful tools and materials for use with IFRS 4 Phase II implementation in the appendices.

If you have any queries or wish to discuss any of the issues in more detail, please speak to your PwC contact or one of the contacts listed in the back of this publication.



Angie Blomberg

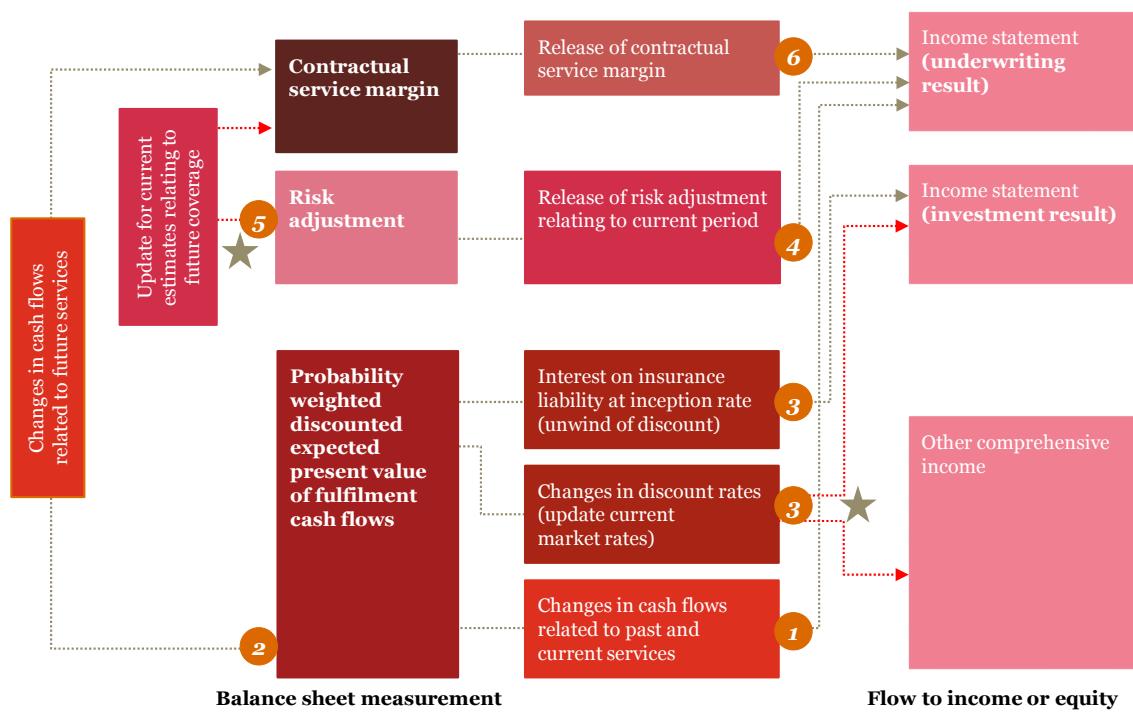
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1. Where the new IFRS is heading

With most of IFRS 4 Phase II now finalised for non-participating contracts, insurance companies can begin to evaluate what the changes mean for their businesses with some certainty.

IFRS 4 Phase II is designed to bring greater comparability to what is at present a diverse patchwork of national approaches to liability measurement. The foundations for the new standard are a series of building blocks ('building block approach' or 'BBA') for liability measurement (see Figure 2). This is the model applied to non-participating contracts. The model for short-duration contracts is discussed on the next page.

Figure 2: Overview of the balance sheet liability building blocks and consequent flows to income



★ Change in IASB re-deliberations since 2013 exposure draft

Source: PwC analysis of latest IASB proposals

So how will this work? The standard applies to all contracts that meet the definition of insurance, which depends on whether significant insurance risk is transferred to the insurer, and is largely unchanged from current IFRS 4. The liabilities are measured as the amount required to fulfil the contract over its lifetime, with three components coming together to provide the evaluation:

- The probability weighted estimate of the future cash flows to fulfil the contract discounted for the time value of money (which for simplicity in this publication, we term 'best estimate liability').
- An adjustment for risk is included to reflect the compensation the insurer requires for bearing uncertainty.
- The contractual service margin ('CSM'), which represents the future unearned profits of the contract to be recognised in profit and loss over the life of the contract. It eliminates any day one gain on the contract by deferring the recognition to future periods. Expected losses on onerous contracts on day one are recognised immediately in profit or loss.

As would be expected in an industry with diverse products, there are some exceptions:

- The measurement of contracts with participating features incorporates additional principles to reflect the link to underlying returns for these contracts (see next section for more details).
- For short duration contracts, the business can elect – if certain requirements are met – to apply a simplified model (the ‘premium allocation approach’ or ‘PAA’) to measure the pre-claims liability (liability for remaining coverage). This measures the liability based on the premium received in the period less acquisition costs paid and amounts recognised as insurance contract revenue as a proxy for the BBA model. In the post-claims period, the BBA model is applied for the liability for incurred claims.
- In addition, investment components, goods and services and embedded derivatives in certain circumstances are required to be separated from insurance contracts and recognised and measured under other IFRS standards.

The changes in the balance sheet measurement in Figure 2 will flow to the income statement or other comprehensive income as indicated in Figure 3:

Figure 3: Flow of changes in balance sheet measurement

-
- 1** Changes in cash flows related to past and current services are recognised in the underwriting result in the income statement. For example, current period mortality experience variance.
 - 2** Changes in cash flows related to future services are recognised against the CSM, unless the CSM is exhausted. In that case these changes are recognised in the underwriting result. For example, the impact arising from a change in lapse assumptions would be recognised against the CSM, unless it is exhausted.
 - 3** Entities have an accounting policy choice to recognise changes in discount rates either in the investment result in the income statement or in other comprehensive income. As a result of this policy choice, interest on the insurance liability will be recognised at the locked-in rate at inception or at a current rate in the investment result in the income statement.
 - 4** The release of the risk adjustment relating to the current and past periods is recognised in the underwriting result in the income statement.
 - 5** The update of the risk adjustment for current estimates relating to future coverage is recognised against the CSM.
 - 6** The release of the CSM according to the services provided is recognised in the underwriting result in the income statement.
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Source: PwC analysis of latest IASB proposals

Following the publication of an exposure draft in July 2013 and subsequent discussions in 2014, the IASB has updated a number of specific areas from the requirements in the exposure draft. For our observations on the 2013 exposure draft, please see our [Practical Guide to insurance contracts¹](#). The following table summarises some of the more significant tentative decisions made by the IASB since the 2013 exposure draft and their potential implications:

¹ <http://www.pwc.com/gx/en/insurance/practical-guide-to-ifrs-insurance-contracts.jhtml>

Figure 4: Summary of tentative IASB decisions

Change	Potential implications and open questions
Discount rates	
<ul style="list-style-type: none"> Accounting policy choice to present changes in the discount rate in either profit or loss or other comprehensive income ('OCI') which should be applied to similar contracts, considering the portfolio in which the contract is included and the related assets that the entity holds. Additional guidance for setting discount rates where there is limited market data. 	<ul style="list-style-type: none"> Eliminates some mismatches in profit or loss arising from the 2013 exposure draft as only limited assets are permitted an OCI presentation under IFRS 9. For non-participating contracts, entities have to assess the level at which this accounting policy should be applied in their specific circumstances or where this election should be used to avoid accounting mismatches. The scope of permitted discount rate extrapolation methods will be an area of judgement and interpretation.
Contractual service margin	
<ul style="list-style-type: none"> Unlocking the CSM for changes in the risk adjustment related to future coverage, and reversing previously recognised losses in profit or loss before reinstating the CSM. Confirmed that accretion of interest on the CSM and calculating the subsequent adjustments that unlock the CSM are both at the day one locked-in discount rates. Amortisation of CSM for non-participating contracts reflects the transfer of service as the basis of passage of time (stand ready obligation) and the expected number of contracts in force. 	<ul style="list-style-type: none"> Greater consistency in the unlocking treatment of changes in the best estimate liability and risk adjustment. Entities will have to track any negative CSM over the life of the contract (including amortisation) to assess which amount should be reinstated if the contract returns to being profitable. Day one locked-in discount rates will be required to be maintained (despite the above mentioned policy choice for changes in discount rates). This could be burdensome for long-term business. Because the initial profit is deferred and the CSM is based on day one economic assumptions, volatility may arise in equity or profit or loss (depending on the accounting policy choice for changes in discount rates) as market conditions change over the life of the contract. Provides greater clarity than the 2013 exposure draft on how to interpret the requirement to amortise in line with the transfer of service.
Unit of account	
<ul style="list-style-type: none"> Amend the definition of a portfolio of insurance contracts to be: 'Insurance contracts that provide coverage for similar risks and are managed together as a single pool'. At initial recognition, onerous contracts are not permitted to be aggregated with profit-making ones in determining the CSM. Clarified that the objective of the standard is to measure an individual insurance contract liability, but that in applying this companies could aggregate insurance contracts provided that it meets this overall objective. Examples to be provided in the final standard to show how this can be achieved when releasing the CSM after inception. 	<ul style="list-style-type: none"> The removal of the reference in the 2013 exposure draft to contracts that are not 'priced similarly relative to the risk taken on' will reduce the number of distinct portfolios. The definition of portfolio may impact whether contracts with unisex rates or universal rates for different age groups are viewed as onerous at inception. Onerous contracts at the outset will need to be tracked separately. The examples may set the precedent for the level of granularity required in the actuarial models and may determine the level of cross-subsidies/pooling between contracts. This will impact the operational challenges and financial results on implementing IFRS 4 Phase II.

Change	Potential implications and open questions
Premium allocation approach (PAA)	
<ul style="list-style-type: none"> Revenue is recorded on the basis of the passage of time and the expected number of contracts in force. However, if the expected pattern of release of risk differs significantly from the passage of time, then revenue would be earned on the basis of expected timing of incurred claims and benefits. When an entity presents the effect of changes in discount rates in OCI, the discount rate that is used to determine the interest expense for the liability for incurred claims in the PAA should be the rate locked-in at the date the claim was incurred. Clarifies that contracts acquired through a portfolio transfer or a business combination should be accounted for as if they had been issued by the entity at the date of the portfolio transfer or business combination. 	<ul style="list-style-type: none"> The pattern of services reflects either the passage of time or the expected timing of incurred claims. This could imply, for example, for hurricane insurance that the entire revenue should be recognised in the hurricane season, rather than spread out over the year. Entities will need to consider what the most appropriate reflection for each type of product is. This modification is expected to be welcomed by non-life insurers intending to use the PAA approach for the pre-claims liability as it means systems do not need to track the discount rate at inception of the contract.
Insurance contract revenue	
<ul style="list-style-type: none"> Income statement definition of revenue in the 2013 exposure draft has been retained. Revenue is determined each period from expected claims and the release of the risk adjustment and CSM. Investment components are excluded from revenue. Presentation of premium information, such as premiums due or written, in the income statement that is not consistent with this definition of revenue is prohibited. 	<ul style="list-style-type: none"> The definition of revenue continues to represent a significant change to current measures, such as premiums written or due, adopted in the life insurance sector. The prohibition of using premiums due or written will prevent entities from using such measures as a starting point on the face of the income statement.
Reinsurance	
<ul style="list-style-type: none"> After inception, where changes in estimates of cash flows on a direct insurance contract impact profit or loss are offset by corresponding changes on a reinsurance contract, these should be recognised in profit or loss. 	<ul style="list-style-type: none"> Removes a potential asymmetry between direct and reinsurance contracts in the 2013 exposure draft for subsequent measurement. For profitable reinsurance contracts at inception that offset losses on direct insurance contracts, a CSM is setup in line with the 2013 exposure draft.

Source: PwC analysis of latest IASB proposals

A few smaller changes are also proposed for fixed-fee contracts, the definition of an insurance contract and the principles in changing accounting policy for the recognition of changes in the discount rates. In addition, the changes for business combinations and portfolio transfers discussed above for the PAA apply to the BBA as well. However, they are generally likely to have a smaller impact.

During its re-deliberations, the IASB decided that it would not consider other topics on the measurement model and disclosure requirements raised in comment letters on the 2013 exposure draft. Such topics included the risk adjustment confidence level disclosure, contracts boundaries and separating components from an insurance contract. Therefore the requirements proposed in the 2013 exposure draft will remain unchanged for these topics and companies can begin assessing the impact now.

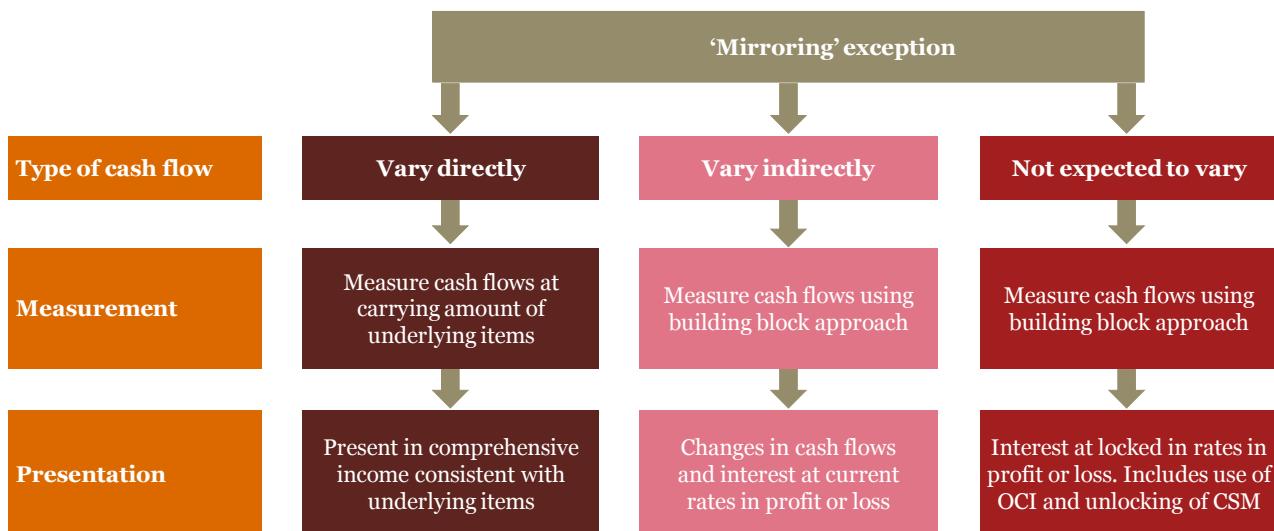
2. What is the approach for participating contracts?

A number of matters on the treatment of participating contracts continue to be examined by the IASB. The outcome of these discussions remains uncertain. This is expected to be the last significant hurdle facing the IASB before a final standard can be published.

The story so far...

The 2013 exposure draft introduced a separate measurement model for certain contracts where the benefit to the policyholder is linked to the return on an underlying item (for example, a certain portfolio of assets) and the insurer is required to hold the underlying item. Figure 5 sets out the model (commonly known as the ‘mirroring’ exception).

Figure 5 – 2013 exposure draft model for the ‘mirroring’ exception.



This model was expected to apply to many types of participating contracts written globally such as UK-style ‘with-profits’ contracts, Continental European participating contracts, unit linked and variable annuity contracts. The set of contracts is wider than the definition of a ‘discretionary participating feature’ in current IFRS 4.

For contracts where there is a link to the return on the underlying items, but the insurer is not required to hold the underlying items (for example, US-style universal life contracts), then the BBA is applied as for other types of contract. The only addition is that the discount rates for interest expense in profit or loss are updated when the insurer expects any changes in the returns on the underlying items to affect the amount of those cash flows.

The proposed ‘mirroring exception’ was challenged by many of the respondents to the 2013 exposure draft due to the perceived complexity (amongst other concerns). As a result, the IASB has spent significant time during its re-deliberations on the approach for participating contracts, including considering an alternative approach developed by the European industry. However, as of the date of this publication no conclusions have been reached. The IASB has taken some directional decisions, but it will consider the proposed model in its entirety at the end of the project. A number of alternative directions are still open to the IASB.

We set out in the next section the key areas that are being discussed.

What are the key areas being discussed?

1. Scope

To which contracts does the separate model apply? As we outlined earlier, the 2013 exposure draft drew a dividing line for those contracts where the benefit to the policyholder is linked to the return on an underlying item and the insurer is required to hold the underlying item.

In recent discussions, the IASB has considered dividing contracts which result in payments to policyholder that vary with returns on underlying items ('participating contracts') into separate categories, for example, depending on the proportion of the total benefit to policyholders that varies with the return on the underlying items and whether there is a minimum amount that the insurer must retain. Until the final model is known it is unclear whether being within or outside the scope significantly affects the measurement of the liability and income statement presentation.

2. Splitting of cash flows

The requirement to split cash flows in the 2013 exposure draft into three types (as set out in Figure 5) was highlighted by many respondent as overly complex, potentially arbitrary and risked introducing accounting mismatches in the model.

The IASB is currently exploring approaches that do not involve the splitting of cash flows including a current single yield curve for discounting the liabilities on the balance sheet.

We understand that whether a form of mirroring exception (for directly varying cash flows) is required in certain circumstances will be considered later in the re-deliberations.

3. Determining interest expense in profit or loss

How should interest expense in profit or loss be determined? Two approaches are being explored by the IASB for determining the discount rates used for income statement presentation:

- 'Book yield' approach: The discount rate is set to reflect the investment return reported in profit or loss for assets backing the liabilities under the accounting model that applies to those assets.
- 'Effective yield' approach: The discount rate is set using the effective interest method as adopted in an amortised cost measurement of assets. This could be on level yield or projected crediting rate basis.

It is not clear so far which of these will be mandated for all or part of the range of participating contracts. It is expected that if adopted, the IASB is likely to seek to limit its application to when the approach reduces or eliminates accounting mismatches.

4. Unlocking and amortisation of the CSM

One of the more significant areas of debate centres on the circumstances under which the CSM is unlocked for the movement in the insurer's share of underlying items. This was prohibited in the 2013 exposure draft, but was noted by many respondents to result in a more realistic representation of performance reporting. The IASB is considering whether such unlocking of the CSM could be permitted for certain participating contracts when these changes are viewed as an implicit management fee, using an analogy to unit linked contracts.

Additionally, the IASB is to discuss what constitutes an appropriate pattern for the transfer of services in a participating contract. This pattern would be used to release the CSM in profit or loss over the contract life.

5. Presentation of changes in the value of options and guarantees

In the 2013 exposure draft, for contracts in the scope of the mirroring exception, all changes in the value of options and guarantees would be presented in profit or loss. While for other participating contracts and non-participating contracts such changes would be split between profit or loss, OCI or unlocking the CSM on the balance sheet depending on the driver for the change as set out previously in Figure 2.

The IASB is likely to discuss this presentation as part of its re-deliberations including the situation where the insurer has hedging instruments in place for the options or guarantees (which are typically reported in profit or loss).

3. Looking at other reporting developments

Insurers are facing changes to how they evaluate assets, recognise revenue and assess capital requirements (in Europe) on top of the shift in accounting liability measurement under the new insurance contracts standard. It's therefore important to look at these reporting developments together, along with differences in implementation timing that could further complicate transition.

IFRS 9 (financial instruments)

What's changing?

IFRS 9 will replace IAS 39 (effective from 2018). Under IFRS 9, there will be three categories of assets, based on the business model and contractual cash flows:

- Amortised cost (AC).
- Fair value through other comprehensive income (FVOCI).
- Fair value through profit or loss (FVPL).

For example, debt instruments could be in either of the three categorises depending on the characteristics of the asset and the business model for managing the asset. While equity instruments are either categorised as FVOCI or FVPL.

For a detailed review of the changes to classification and measurement requirements, please see our [in depth²](#) publication.

There will also be changes to impairment rules for debt instruments (such as corporate bonds) classified as AC or FVOCI. A 12 month expected credit loss assessment or, where there is a significant increase in credit risk, a lifetime loss assessment is required. Compared to the current incurred loss model, this will result in earlier recognition of credit losses and therefore the potential for greater volatility in profit or loss.

For more information on the impairment requirements, please see our [in depth³](#) publication.

IFRS 9 contains new hedging guidance and the IASB has also issued a discussion paper on the topic of macro-hedging. To date, insurers have used hedge accounting less extensively than banks.

The interaction with IFRS 4 Phase II

The relationship between assets and liabilities is integral to the management of insurance contracts and therefore the move to IFRS 9 will have an important bearing on IFRS 4 Phase II.

While the expected implementation timelines for IFRS 9 and IFRS 4 Phase II are at present broadly in line, the risk of delay in IFRS 4 Phase II means that companies would need to consider the interactions for both current and future insurance contract accounting and take account of any transition measures that may be permitted

² <https://inform.pwc.com/inform2/show?action=informContent&id=1432051608151978>

³ <https://inform.pwc.com/inform2/show?action=informContent&id=1415113308150843>

under IFRS 4 Phase II. This would require careful consideration to avoid the introduction of accounting mismatches when IFRS 4 Phase II is adopted.

IFRS 15 (revenue)

What's changing?

IFRS 15 is a standard that is not yet high on the list of priorities of many insurers. The standard impacts those contracts written by an insurer that do not transfer significant insurance risk or contain a discretionary participating feature. Such contracts are often referred to as non-participating investment contracts with a common example being some unit linked pension contracts. The new standard replacing IAS 18 will become effective from 2017.

The implications for insurers

IFRS 15 may impact the deferral and subsequent amortisation of acquisition costs and initial fees on non-participating investment contracts. Insurers will need to assess the impact on their businesses.

Solvency II (for European insurers)

What's changing?

While there are conceptual similarities between the approaches that underpin Solvency II and IFRS 4 Phase II, there are a host of differences. Appendix I provides a high level comparison between the two.

The implications for IFRS 4 Phase II

Given the investment in Solvency II and potential for synergies with IFRS 4 Phase II in areas such as data collection, modelling systems and reporting lines, it would clearly make sense to use what's being put in place as the starting point for IFRS 4 Phase II implementation.

Solvency II will be effective some way before IFRS 4 Phase II. In this interim period, the current IFRS 4 would remain the accounting standard, though companies can change the accounting policies if the new policies are deemed to be more relevant and/or reliable. This may open up the opportunity to realise practical synergies with Solvency II within this interim period, although care will be needed to ensure any changes meet the relevant and reliable criteria. Tax implications may also be an important consideration.

Future supplementary reporting

Insurers, particularly life insurers, disclose a range of supplementary measures to address perceived limitations in both current accounting and regulatory regimes in assessing key aspects of profitability, liquidity and capital in a consistent way. Examples include embedded value, value of new business, cash remittances, operating profit definitions and other predictors for cash generation.

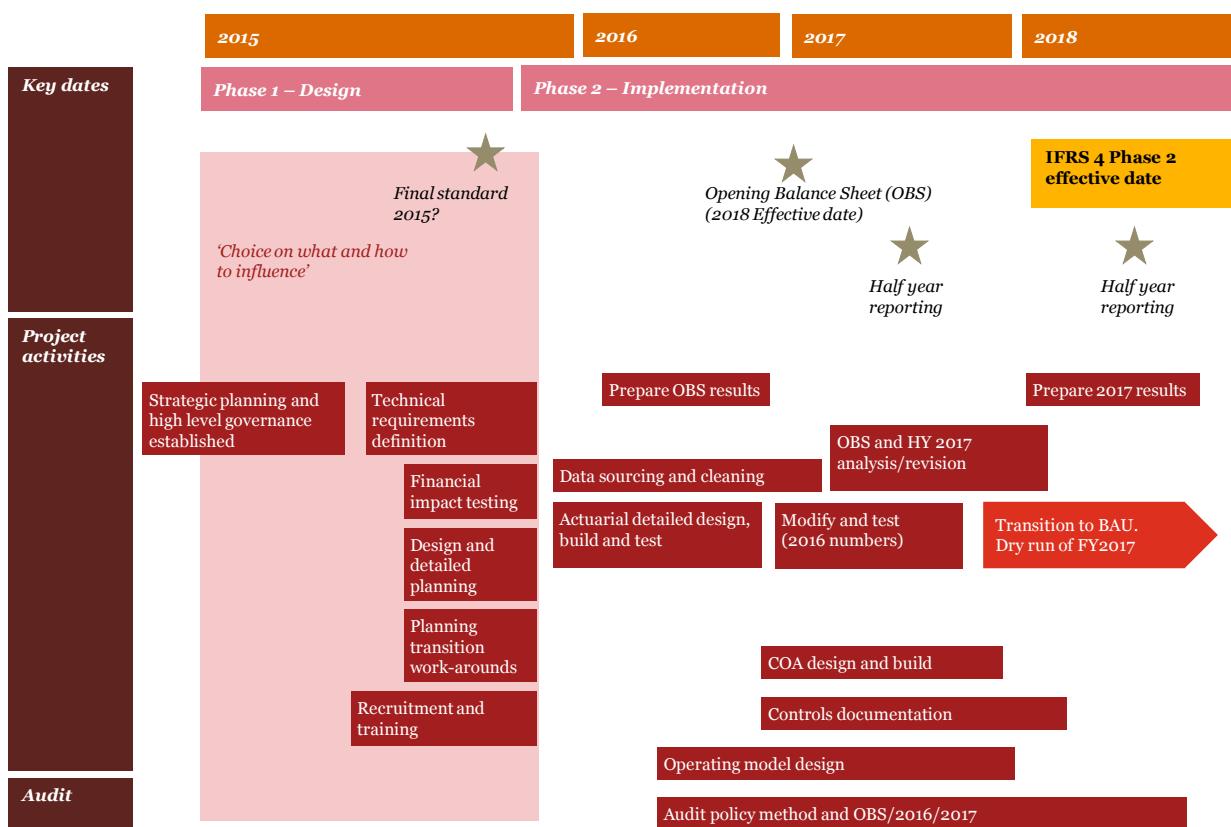
There is a possibility that some of these metrics may disappear in the future, though the complex nature of cash generation within insurance means that multiple bases of disclosure may continue even after the move to Solvency II (in Europe) and IFRS 4 Phase II (more widely). Supplementary measures might include an alternative assessment of the value created from writing new business and the future profits expected from in-force contracts.

4. Laying the foundations

There may be a reluctance to devote too much time and effort in preparing for IFRS 4 Phase II given its history of delays and the resources that are already tied up with other pressing priorities including Solvency II in Europe. But now we're moving into the end game, it's important to start assessing the impact, laying the ground for implementation and making time work for your organisation rather than against you. What could insurers be doing now to get up to speed and minimise future cost and disruption?

For many insurers, IFRS 4 Phase II tends to be a second order priority at present due to uncertainty over timing of the final standard. Unless heavily involved in lobbying, most companies have been focused on monitoring developments. But with a possible effective date in 2018 or 2019 and with the requirement to provide comparatives at this date from the end of 2016 (or even earlier for SEC reporters), the need to get into gear and use the time in the most effective way becomes more pressing. Figure 6 sets out a possible road map for an IFRS 4 Phase II project under the assumption of an effective date of 2018.

Figure 6: Illustrative roadmap for an IFRS 4 phase II project with an assumed effective date of 2018



Addressing system changes including actuarial and reporting systems is an important element of making time on your side. The development life cycle can take 18 months to two years. Moreover, it's important to assemble the right team now as competition for the people who understand the technicalities and can implement the changes can only increase as we move towards full implementation.

Some insurers are going further by using the moves to Solvency II and IFRS 4 Phase II as a catalyst for modernising their risk, actuarial and finance functions and developing more effective data capture and supply

from within the business. The quicker the implementation and the more efficiently these operations work then the lower the risk of mistakes and re-statements when the new requirements go live. Moreover, key personnel will have more time to advise the business once they're freed from endless rounds of implementation and manual intervention to keep the reporting system running.

A particular advantage of getting into gear early is the ability to build up a log of accurate and relevant data, which will give companies a much better chance of gaining an appropriate CSM on transition to the new standard. For the same reasons, it is important to investigate how to make the most of any embedded value data to assist in transition preparations.

So what are the key areas of focus?

1 Actuarial systems

While it will be possible to draw on embedded value, Solvency II or other current evaluations to generate best estimates of liabilities and risk adjustment, there are expected to be a number of differences between the bases (as can be seen in the appendix comparison). In addition, new systems and functionality will be needed for the CSM as there is no equivalent concept under Solvency II or in most current reporting.

Detailed consideration of the available options will be required to ensure results are prepared on time and at the level of detail required.

2 Data, interfaces and reporting systems

New data will be required for the liability calculations and reporting disclosures. The level to which calculations are required (unit of account) could have a significant cost implication. The reporting flows and interfaces will need review and possible updating as a result. A fundamentally different style of income statement (notably for life insurers) is also likely to necessitate what could be a significant overhaul of general ledgers, consolidation tools and reporting.

3 Operating model for Actuarial, Risk and Finance

This standard will require even further collaboration, understanding and consistency across these functions, whether these functions are distinct or integrated. Further integration and cohesive working between these skills will become even more essential in an IFRS 4 Phase II world.

4 Strategic implications

As the treatment of participating contracts is still a moving target, this is one area where it is too early to consider changing the business or products. We suggest following the potential implications to prepare for when the standard is out and prepare in more detail when the requirements are likely to be clearer in 2015.

For non-participating contracts, there is now enough certainty to begin looking at how the new IFRS will affect the way particular products and the business as a whole are valued and judged by the financial markets. Key challenges include: How to manage the potential for heightened earnings volatility? Where might companies need to adjust their portfolios or product features? How can they explain the changes to analysts and investors?

5 Management implications

From a management perspective, a significant challenge is identifying the right suite of key performance indicators during this period of change and thereafter. Depending on the jurisdiction, the current accounting and regulatory measures may be those used to calculate local tax. Moreover, insurers with US operations, a US parent or Foreign Private Issuers using US GAAP, will need to continue to consider US GAAP developments as there will not be a single global converged accounting standard for insurance contracts.

6 Other projects and competition for resources

Besides IFRS 4 Phase II, insurers are facing many other challenging projects, such as Solvency II (in Europe), IFRS 9, IFRS 15 and increased focus on capital for those viewed as globally systemic, to name a few. The insurance industry lacks a deep pool of skilled resources that can get these projects over the finish line. It is crucial to identify the resources available, increasing the pool of resources available to support the industry and use specialists in the most effective way.

5. Conclusion: Ready to go

While the path to IFRS 4 Phase II has been long, it now appears that the finish line may be in sight. We believe that there are a number of key questions that companies will need to address to make sure they are effectively preparing for it:

- Do you understand how this standard could impact your business, both in terms of your results, but also how much it will cost to implement?
- Are your current actuarial, risk and finance systems equipped to deal with the new IFRS?
- How can you make the most of the synergies with the systems and processes being developed for Solvency II (if applicable) or other global/local developments?
- How will IFRS 4 Phase II affect the volatility and trajectory of earnings?
- What is the best option for reporting between now and full implementation?
- Are you aware of the availability of data in your systems for the measurement of insurance contracts on transition and afterwards?

In order to make the best use of the time before the standard will become effective and to effectively manage costs in the long run, it will be important to plan early, identify resources, consider the linkages with other reporting regimes such as Solvency II (and other global / local developments) and understand the potential financial impacts. Appropriately considering each of these factors will better place companies to effectively manage the long term impacts of this significant new accounting standard.

Appendices

Appendix I – Solvency II / IFRS 4 Phase II comparison for contract liabilities

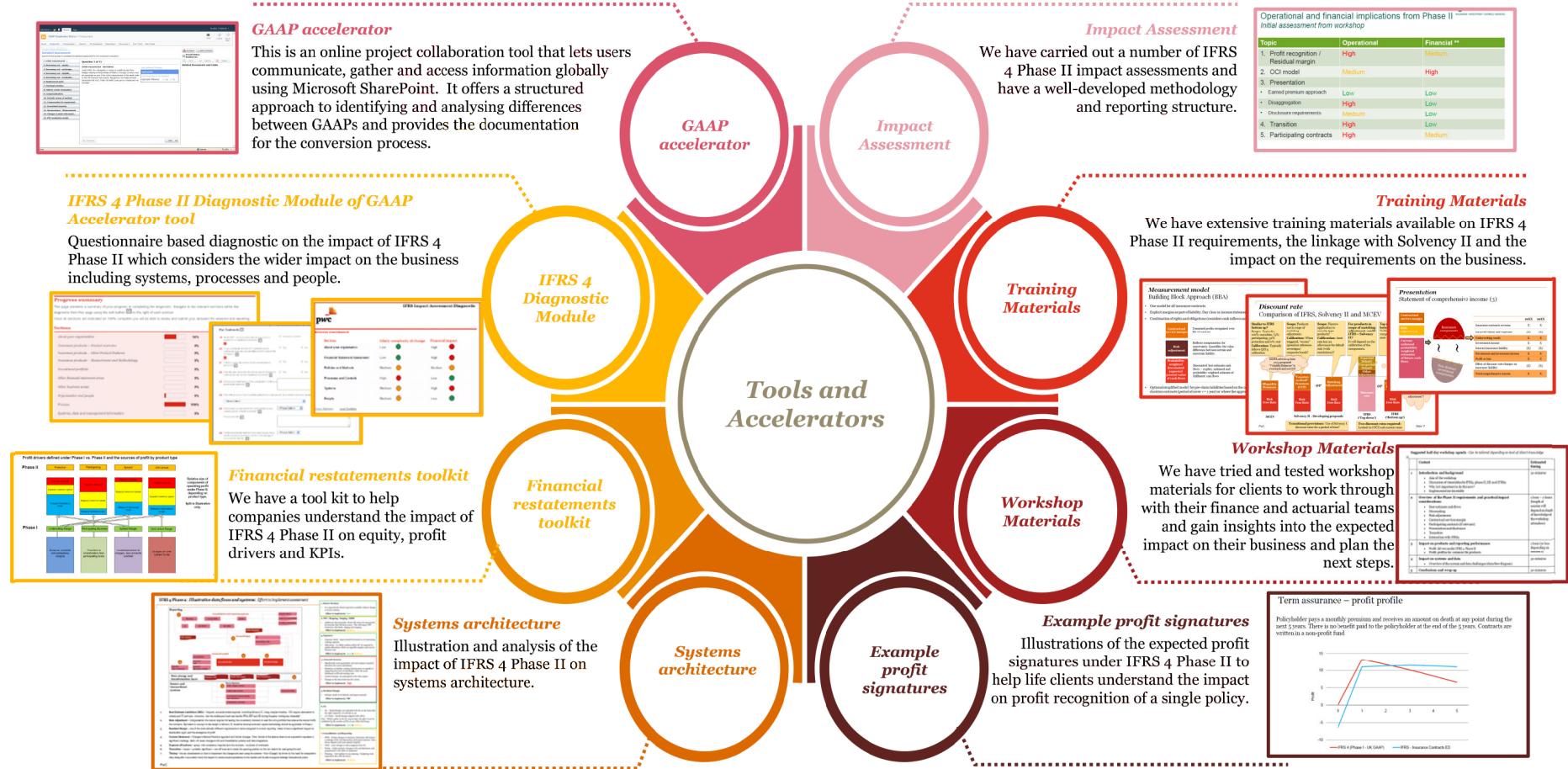
This appendix sets out an at-a-glance summary comparison of the expected main differences between IFRS 4 Phase II and Solvency II contract liabilities. The colour coding provides a guide to the significance of the difference for each topic when considered for a typical insurer across technical, financial and operational considerations. Green (L) refers to low, amber (M) to medium and red (H) to high.

Topic	Solvency II	IFRS 4 Phase II	Observations	Significance
Definition and scope	All contracts regulated as insurance	Insurance and participating investment contracts only	The measurement of non-participating investment contracts in IFRS is significantly different to Solvency II reflecting: (i) the deferral of revenue and expenses (required under IFRS 9/IFRS 15); and (ii) the existence of the surrender value (deposit) floor (required under IFRS 9). Solvency II is a current assessment.	M
	Insurers in specific jurisdictions only	All entities that write insurance contracts	Solvency II will only apply to regulated insurance companies in specific jurisdictions (and groups containing such companies).	L
Unbundling	Separate unbundling for the purposes of different contract boundaries and segmentation	Unbundling for non-insurance components (distinct investment components, embedded derivatives and certain goods and services)	There is no concept in Solvency II of unbundling non-insurance components and assessing them under a different standard. Where investment components are unbundled in IFRS then the measurement can be different to Solvency II (as noted under ‘definition and scope’ above). The implications for contract boundaries are considered below.	M
Recognition	Earlier of the date that the insurer becomes party to the contract and the date the cover begins	Earlier of the date coverage begins or the first premium is due; with an onerous contract test for prior period	For many contracts the recognition point will be the same.	L
De-recognition	Obligations are extinguished, discharged, cancelled or expired	Obligations are extinguished or upon substantial modification of the contract	Likely to be the same across all metrics.	L

Topic	Solvency II	IFRS 4 Phase II	Observations	Significance
Granularity/ Unit of account	Defined lines of business Risk margin is allocated to each line of business from an initial entity level assessment	Standard provides objective to measure an individual contract Maximum level of aggregation is the portfolio level	Differences may exist between the granularity of components in IFRS and Solvency II with operational implications for actuarial models. In IFRS, it is expected that the level of granularity will be lower than the portfolio level, for example, to calculate the contractual service margin.	M
Contract boundary	No longer required to provide coverage or can amend price to 'fully reflect risk' at the portfolio level (unless individual underwriting took place)	No longer required to provide coverage or can amend price to 'fully reflect risk' at the contract level with additional requirements for an assessment at the portfolio level	The contract boundary might be different. Both Solvency II and IFRS permit a boundary based on a re-pricing assessment, although in practice, the exact requirements under each approach might still produce a different boundary. In Solvency II, there is an additional requirement to unbundle components that have different contract boundaries. In addition, there is no projection of premiums for savings contracts under Solvency II that is they are treated as being paid-up.	M
Cash flows (excluding acquisition costs)	Prescribed (gross of reinsurance)	Relate directly to the fulfilment of the portfolio (gross of reinsurance)	Solvency II requirements are more prescribed than IFRS and hence there is less scope for interpretation. Different cash flows might be included, for example, certain overhead expenses might be excluded under IFRS, and the timing of recognition for expected cost savings might be different.	M
Acquisition costs	Expensed as incurred	Implicitly deferred through contractual service margin	Unlike IFRS, there is no deferral of acquisition costs under Solvency II.	H
Discount rate	Prescribed based on swaps less credit risk (plus matching adjustment or volatility adjustment)	Either a top-down or a bottom-up is permitted	Conceptually, a top-down approach in IFRS is similar to Solvency II with the application of a matching adjustment. The criteria required to be met; application to liabilities and calibration of the adjustments to the risk-free rates might be significantly different between each metric. For example, the Solvency II volatility adjustment is not liability dependent and is unlikely to be permissible under IFRS. The risk-free rates (swaps less credit risk), volatility adjustment and significant components of the matching adjustment will be published by the European Insurance Regulator (EIOPA).	M

Topic	Solvency II	IFRS 4 Phase II	Observations	Significance
Risk allowance	<p>Prescribed approach using 6% cost of capital</p> <p>Set at the reference undertaking (entity) level with defined risks and level of diversification benefits</p>	<p>No prescribed technique</p> <p>Entity's own view of risk and diversification benefits</p>	The Solvency II requirements are highly prescribed and differences may arise with IFRS, for example, the technique applied; the calibration adopted; the level of diversification benefit etc.	M
Profit recognition	<p>Day one profit is recognised (for all contracts, including reinsurance)</p> <p>Experience variances and assumption changes are fully recognised in the period</p>	<p>Contractual service margin eliminates day-one gain and defers profit over the coverage period</p> <p>Contractual service margin is unlocked for certain changes to assumptions and can be reinstated</p>	<p>Solvency II is not designed as a performance reporting metric.</p> <p>The contractual service margin is a key driver in the timing of profit recognition under IFRS and applies retrospectively. As a result, profit emergence will differ.</p>	H
Non-life and other short duration contracts	No separate model exists (although non-life techniques may differ and premium and claim provisions are separately measured)	Premium Allocation Approach (pre-claims liability) and cash flow projection (incurred claims)	Use of the Premium Allocation Approach in IFRS is optional; hence it is permissible to apply the full measurement model as for other contracts.	M
Participating contracts	Cash flows include all discretionary payments (except for 'approved' surplus funds)	TBC	Some similarities would be expected. However, given the current development of the IFRS 4 Phase II model it is too early to conclude.	TBC
Reinsurance contracts – presentation and measurement	Liabilities are presented gross of reinsurance and a separate reinsurance asset is held (except for risk margin)	Liabilities are presented gross of reinsurance and a separate reinsurance asset is held (including risk adjustment)	Reinsurance recoveries are recognised, measured and presented separately (except for the allowance for risk) under Solvency II and IFRS, allowing for the non-performance risk of the reinsurance counterparty.	M
Business combinations and portfolio transfers	Recognised, measured and presented as if written by current entity	Additional recognition, measurement and presentation principles apply at the point of combination/transfer	Purchase accounting applies under IFRS with additional presentational requirements. No equivalent under Solvency II.	H

Appendix II – Tools and materials for IFRS 4 Phase II implementation



Addressing the practicalities

PwC is helping a range of insurers to assess the implications and address the practical challenges of preparing for IFRS 4 Phase II. If you wish to discuss any of the issues raised in this paper or other aspects of the frameworks, please speak to your PwC contact or one of the following:

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We are grateful for the efforts of partners and staff that assisted in the production of this publication. In particular, we would like to thank Matthew Donnery, Bob Owel and Leslie Vermaak.



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141001-100223-BO-OS