IFRS Update:
Insurance Contract Project & Other Developments
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What is IFRS?

International Financial Reporting Standards (IFRS)

- IFRS is a high-quality, comprehensive, globally-accepted set of accounting standards
- In many instances, IFRS contains similar concepts as U.S. GAAP
- IFRS is a less extensive body of literature than U.S. GAAP, with limited industry-specific guidance
- There are more circumstances where application of IFRS will require exercise of judgment, supported by contemporaneous analysis
- IFRS requires clear, transparent disclosures of critical accounting policies and estimates

Differences with U.S. GAAP come in all shapes and sizes

- Different levels of detail
  - Disclosure requirements, including financial instruments, insurance liabilities
- Different approach to industry-specific guidance
  - Types of entities vs. activities
- Different concepts/ approaches
  - Special purpose entities versus variable interest entities, QSPE's
  - Revaluation of non-financial assets (PP&E, Intangibles)
- Differences in scope
  - Employee share compensation (U.S. GAAP) vs. All share-based payments (IFRS)
- Differences in the details
  - Accounting for leases
  - Impairment of financial assets
  - Derivatives
  - Effective dates and transition (SFAS 123(R) vs. IFRS 2)
  - Accounting for income taxes

Current Status of IFRS Globally and SEC Proposed Roadmap

SEC agreed to propose roadmap pointing towards mandatory IFRS adoption by all U.S. public companies

- August 27, 2008: SEC agreed to propose roadmap for potential adoption of IFRS by all U.S. public companies
  - Proposed roadmap identifies milestones with progress towards achievement being monitored by the SEC staff before SEC considers mandatory adoption of IFRS. Milestones include: continued improvement in IFRS largely through convergence efforts between FASB and IASB, improved IASB accountability and funding stability, development of an IFRS XBRL taxonomy comparable to the U.S. GAAP XBRL taxonomy, and IFRS education and training for preparers, auditors, investors, and incorporation into college and university curricula
  - Proposed optional adoption of IFRS by a limited number of companies (see next slide)
  - Next steps
    - 2008/2009: Proposal issued in November 2008, with initial comment period of 90 days beginning with publication of proposal in Federal Register. Comment period later extended to April 20, 2009
    - 2009: Roadmap issued; ability of limited number of companies meeting screening criteria to elect to use IFRS
    - 2009 - 2011: SEC staff to monitor progress against roadmap milestones
    - 2011: SEC to consider mandatory use of IFRS by all U.S. public companies; if so,

      SEC may permit early adoption by all public companies
    - 2014 - 2016: Potential phased-in IFRS adoption, starting with large accelerated filers in 2014, accelerated filers in 2015, remaining companies in 2016
- December 2007: SEC issued final rule permitting foreign private issuers to file financial statements in accordance with IFRS as issued by IASB (SEC No. 33-8879)
  - No reconciliation to U.S. GAAP needed

Joint IASB/FASB efforts

- Convergence continues, with the following key projects: Revenue recognition, Financial statement presentation, Lessee accounting, Postretirement benefits, Financial instruments at fair value, Derecognition, Consolidation policy, Fair value measurement, Income taxes, Insurance contracts

Worldwide

- Over 100 countries either require or allow IFRS for listed companies
- Other countries have plans to adopt or converge to IFRS by 2011:
  - Brazil, Canada, India, Israel, China, Japan, South Korea

Proposal for Optional Adoption of IFRS by Limited Number of Large U.S. Issuers

Early adoption proposal

- Would allow a limited number of large U.S. public companies to begin preparing financial statements in accordance with IFRS as early as years ending on or after December 15, 2009

Who would qualify?

- Criteria (or "screens") to qualify:
  - Peer-group companies, determined by two-digit SIC code or another common industry-classification scheme, report financial information using IFRS as issued by IASB more frequently than any other basis of accounting. Peer-group defined as 20 largest companies in the industry (globally) based on market capitalization
  - Candidate early-adopter must be one of the 20 largest companies
- The SEC staff estimates that at least 110 U.S. public companies may meet these requirements
  - These companies represent approximately 14% of U.S. market capitalization

What is the process?

- Companies that believe they meet criteria and desire to convert to IFRS would be required to obtain a no-objection letter from the SEC staff
- Three years of IFRS financial statements would be required (e.g. IFRS financial statements for 2007, 2008 and 2009 when issuing 2009 financial statements)
- In year of adoption of IFRS, apply IFRS 1. IFRS 1 requires reconciliation of U.S. GAAP to IFRS in first comparative period (e.g., reconciliation of 2008 financial information when issuing 2009 financial statements)
- Possible additional SEC disclosure requirement
  - SEC release will ask for comment on a potential additional requirement to disclose in each year's annual financial statements an unaudited reconciliation of IFRS to U.S. GAAP for the three years of audited financial statements presented when the company first adopts IFRS and in future years until SEC formally mandates IFRS for all registrants (e.g., reconciliations for 2007, 2008 and 2009 in 2009 annual report and potentially ongoing for 2010-2016 annual reports)

First-Time Adoption Requirements

An assessment of the impact of adopting IFRS is not complete without an understanding of IFRS 1: First-time Adoption of International Financial Reporting Standards, which was developed by the IASB to provide transition guidance to enterprises preparing their first set of financial statements in full compliance with IFRS.

Note: THE IASB is currently considering potential changes to IFRS 1. As a consequences when the company adopts IFRS, the mandatory or optional exemptions could be different than those shown here.

Key elements of IFRS 1

- Be compliant with IFRS standards effective at the reporting date
- Subject to certain exemptions, apply all IFRSs retrospectively;
- An opening balance sheet must be prepared at the transition date, which is the beginning of the earliest financial year presented;
  - The effect of retrospectively applying IFRS to transactions prior to the transition date is generally recognized in equity in the opening balance sheet
- All comparative financial statements and disclosures must be in full compliance with IFRS guidance for recognition, measurement, presentation and disclosures;
- Extensive disclosure is required in the first set of IFRS financial statements to explain the effect of transition. An additional footnote is required to include the following:
  - A reconciliation between previous GAAP, i.e. U.S. GAAP, and IFRS for a) each equity component at the transition date; and at the most recent reporting date under the previous GAAP; and b) profit and loss for the most recent reporting period under the previous GAAP
  - An explanation of material adjustment to the cash flow statement for the most recent reporting period under the previous GAAP

Recent IFRS Developments June 2008 – May 2009

Recent IFRS Developments

- **Amendments to IFRS:**
  - **May 2008—Amendment to IFRS 1, *First-time Adoption of IFRS,* and IAS 27, *Consolidated and Separate Financial Statements,* to allow first-time adopters relief from certain requirements in IAS 27**
  - **July 2008—Amendment to IAS 39, *Eligible Hedged Items—Recognition and Measurement*, which addresses designation of a purchased option as the hedging instrument of an item that contains no optionality, and the hedging of inflation risk**
  - **March 2009—Amendments to IFRIC 9 and IAS 39, *Embedded Derivatives*, to require entities to assess whether an embedded derivative must be bifurcated when an entity reclassifies a hybrid asset out of fair value**
  - **March 2009-Amendment to IFRS 7, *Improving Disclosures about Financial Instruments,* to require disclosures of financial instruments measured at fair value to be based on a three-level fair value hierarchy, and additional disclosures of liquidity risk**

Recent IFRS Developments

- Exposure Drafts:
  - **May 2008—Conceptual Framework, *The Objective of Financial Reporting and Qualitative Characteristics* and *Constraints of Decision-useful Financial Reporting Information***
  - **August 2008—Proposed amendment to IAS 33 on earnings per share, *Simplifying Earnings Per Share,* to simplify the EPS calculation and reduce differences between IAS 33 and FAS 128**
  - **September 2008—Proposed amendment to IFRS 5 on discontinued operations, *Non-current Assets Held for Sale and Discontinued Operations,* to provide a revised definition of discontinued operations and additional disclosures**
  - **September 2008—Proposed amendment to IFRS 1, *Additional Exemptions for First-time Adopters***
  - **December 2008—Proposed amendment to IAS 24 on related party disclosures, *Relationships with the State,* to provide an exemption from related party disclosures for entities controlled or significantly influenced by the state**
  - **December 2008—Proposed amendment to IFRS 7, *Investments in Debt Instruments,* to require additional disclosures on investments in debt securities**
  - **December 2008—Exposure Draft 10, *Consolidated Financial Statements*, which proposes a single control model for all entities, including SPEs**
  - **March 2009—Proposed replacement of IAS 12 on income taxes, *Income Tax,* to address the recognition of deferred tax assets and the measurement of tax assets and liabilities**
  - **March 2009—Proposed amendments to IAS 39 and IFRS 7, *Derecognition*, to focus on the concept of control when assessing derecognition**

Recent IFRS Developments

- Discussion Papers:
  - May 2008—Conceptual Framework, *The Reporting Entity*
  - October 2008—Joint discussion paper with the FASB, *Preliminary Views of Financial Statement Presentation*
  - December 2008—Joint discussion paper with the FASB, *Preliminary Views on Revenue Recognition in Contracts with Customers*
  - March 2009—Joint discussion paper with the FASB, *Leases*
- IFRICs:
  - July 2008—IFRIC 15, *Agreements for the Construction of Real Estate*
    - Determining the applicable accounting standard and revenue recognition timing when accounting for real estate construction agreements
  - July 2008—IFRIC 16, *Hedges of a Net Investment in a Foreign Operation*
    - Determining the foreign currency risk that would qualify for hedge accounting
  - November 2008—IFRIC 17, *Distributions of Non-cash Assets to Owners*
    - Addressing the accounting by an entity that distributes a non-cash asset
  - January 2008—IFRIC 18, *Transfers of Assets from Customers*
    - Determining whether a contributed asset should be recognized by the recipient

Recent IFRS Developments

- Other Activities:
  - **June 2008—IASB establishes a valuation expert advisory panel to assist with enhancing guidance on valuing financial instruments in inactive markets**
  - **October 2008—IASB and FASB commit to a joint approach to deal with reporting issues related to the global financial crisis**
  - **October 2008—FASB joins the IASB in its accounting for insurance contracts project**
  - **October 2008—IASB publishes a report on applying fair value in inactive markets**
  - **April 2009—IASB publishes a detailed six-month plan to replace IAS 39**
  - **Over the year, the IASB worked on projects to address the global credit crisis, including fair value measurements, recognition and measurement, consolidation, derecognition, disclosures, the replacement of IAS 39, and US GAAP/IFRS convergence**

IFRS and Insurance Contracts

IFRS and Insurance Contracts

- **Overview**
  - Project began in 1997
  - Insurance Project provides “extreme” example for several other IASB standards under development
    - Revenue Recognition
    - Fair Value Measurements
    - Financial Statements Presentation
  - Project split into two phases in May 2002
  - Phase I issued in March 2004, and currently in effect
- **Phase II Still Under Development**
  - Discussion paper published in May 2007, with comments due by November 16, 2007
  - 162 Comment Letters received
  - Exposure Draft – December 2009
  - Final Standard – May 2011
  - Implementation – Likely not before 2012
- **FASB joins IASB for Phase II insurance contract standard**
- **Interaction with Solvency II**
  - Solvency II implementation planned for Autumn 2012 (EU mandate)
  - Intent is that valuation of assets and liabilities under Solvency II would be consistent with Phase II, if possible
  - Delays in Phase II implementation could result in “disconnect” between accounting standards and Solvency II

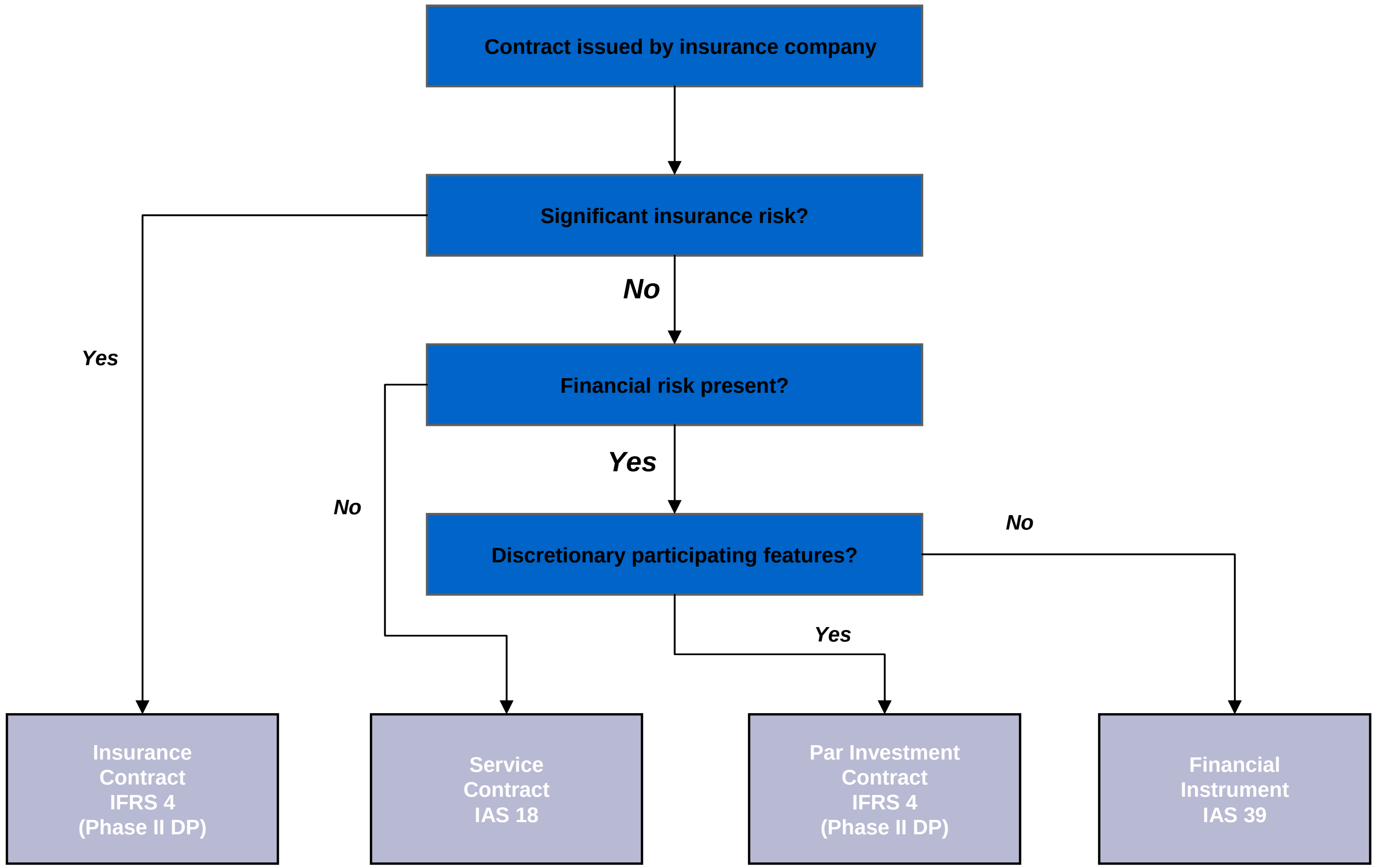
IFRS 4 – Phase I Highlights

- Defines an insurance contract
- Exempts insurers (temporarily) from some requirements of other IFRSs
- Prohibits provisions for possible claims under contracts not in existence
- Requires test for adequacy of recognized liabilities and an impairment test for reinsurance assets
- Prohibits offsetting of asset and liabilities
- Permits changes in accounting policies only if an “improvement”
- Permits re-measuring insurance liabilities to reflect current interest rates
- Requires unbundling under certain circumstances
- Increases disclosure and presentation requirements

IFRS 4 – Definition of an Insurance Contract

- 'A contract under which one party (the insurer) accepts ***significant insurance risk*** from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder'
- Insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefit in any scenario, excluding scenarios that lack commercial substance (i.e. that have no discernible effect on the economics of the transaction) (IFRS 4, B21)
- Consequence – Contracts that do not meet the definition are financial instruments:
  - With different presentation,
  - And different measurement requirements
- An exception to this are investment contracts with discretionary participating features, which are subject to IFRS 4 (Phase I) measurement requirements

Product Classification Diagram



Valuation of Insurance Contracts – Phase I

IFRS 4 Insurance Contracts (Phase I)

Financial Instruments (IAS 39)

All insurance contracts valued using local GAAP

Except

- **Elimination of catastrophe and equalization reserves**
- **Liability adequacy testing**
- **Unbundling of certain embedded derivatives and deposit components**
- **Disclosure and presentation requirements**

Two Principal Disclosures

- **1) Explanation of Recognized Amounts**
  - Accounting policies for insurance contracts
  - Recognised assets, liabilities, income and expenses arising from insurance contracts
  - How significant assumptions used in measurement are determined (and, if practicable, disclose the assumptions themselves)
  - Information about the effect of changes in assumptions
  - Reconciliations of changes in insurance liabilities, reinsurance assets and deferred acquisition costs
- **2) Nature and extent of risks arising from insurance contracts**
  - Objectives, policies and processes for managing risks and the methods used to manage those risks
  - Sensitivity to insurance risk, disclosure options:
    - Qualitative information about sensitivity and terms and conditions of insurance contracts that have a material effect on future cash flows OR
    - Sensitivity information:
      - Sensitivity analysis showing impact on profit and equity of changes in risk variables that were reasonably possible, OR
      - If an alternative method is used to manage sensitivity to market conditions (e.g. EV) disclose such alternative sensitivity analysis.
      - Concentrations of insurance risk
      - Information about credit, liquidity and market risks of insurance contracts (including embedded derivatives not separated) as required by IFRS 7.

Additionally Risk Management Disclosures Greatly Enhanced

Disclosures of:

- What risk is the company exposed to?
- What risk policy is in place?
- How are risks monitored?

General Findings:

- Information both in management report and notes to the accounts
- Different disclosures
- Different level of detail
- Different choices in quantitative/quantitative

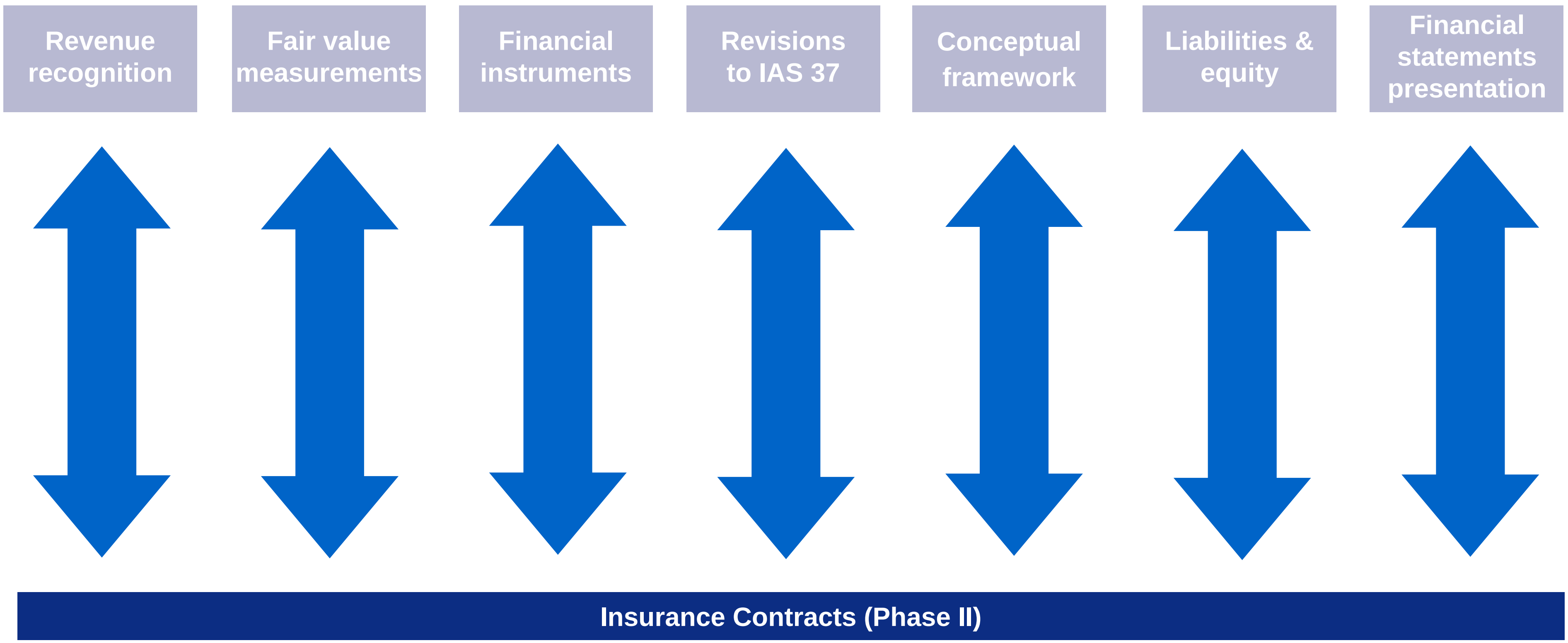
Policies Disclosed:

- ALM/duration matching
- Actuarial models
- Underwriting guidelines
- Reinsurance guidelines
- Profit test/pricing
- Solvency requirements

Monitoring Measures Disclosed:

- Embedded value
- Sensitivity analysis
- Actuarial analysis
- Provisioning/liability adequacy test
- Economic capital/internal modelling

Interaction with Other IASB Projects



Discussion Paper – Preliminary Views on Insurance Contracts

A single model – Life, non-life, direct, reinsurance
Recognition of assets and liabilities should be consistent with financial instruments
DAC and UPR are not recognised as assets/liabilities
Current exit value used to measure liabilities
Recognize future premiums if guaranteed insurability
Future policyholder dividends are liabilities where a legal or constructive obligation exists
Day one profits permitted
Portfolios with similar risk characteristics and common management
Unbundle insurance/deposit components if not arbitrary
Reflected credit characteristics in measurement of insurance liability

Tentative decisions to date following release of DP

Topic	IASB	FASB
Features of a measurement Approach	• Estimates should be as consistent as possible with market prices • Should use explicit current estimates of expected cash flows • Should reflect the time value of money • Should include an explicit risk margin	• Agreed that a measurement of the fulfilment value should use expected cash flows rather than best estimate cash flows • Expected cash flows should be update each period • Cash flows should consider all available information that represents the fulfilment of the insurance contract (i.e. industry data, historical data, market inputs) • Have not discussed time value of money and margins
Measurement objective	• Exit notion *OR* • Fulfilment notion	• Agreed to explore an approach where an insurance contract is measured at a current fulfilment value rather than a fair value (FASB 157).
Measurement of the margin at inception	• Measured by reference to premium • No day one gains should be recognised	• Agreed in principle that initial recognition should not result in an accounting profit • Revisiting this may be necessary after future decisions
Candidate measurement approaches	• In addition to Current Exit Value and Fulfilment Value the board will consider at a future meeting an unearned premium approach for short duration pre claim liabilities	• Will consider an approach using future cash flows with no margin and no discounting in certain instances

Two Measurement Approaches

- Two measurement candidates have emerged as the most likely final measurement approach adopted by the IASB and FASB:
  - Current Exit Value
  - Fulfillment Value
- Current Exit Value
  - The measurement approach described in the Discussion Paper;
  - The amount the insurer would expect to pay to another entity if it transferred all its remaining contractual rights and obligations immediately;
  - Key considerations for Current Exit Value include: cash flows and assumptions that would arise for a market participant taking over the liability;
  - Credit worthiness a consideration.
- Fulfillment Value
  - Introduced as an alternative based on the Discussion Paper comments;
  - The amount the insurer requires to “fulfill” its obligations to its policyholders over time;
  - Key considerations for fulfilment value include: cash flows and assumptions based on the entity’s own estimates and processes;
  - No consideration of credit worthiness needed.

Three Building Blocks

- **Both approaches use 3 building blocks, however Fulfillment Value uses entity specific cash flows:**

- Explicit, unbiased market-consistent, probability weighted current contractual estimates of future cash flows (i.e. a current expected value approach)

- Current market discount rates that adjust the future cash flows for the time value of money

- An explicit unbiased estimate of the margin that market participants require for bearing risk (a risk margin)

Risk Margin

- **Characteristics of Risk Margin**
  - The less that is known about the current estimate and its trend, the higher the risk margin should be.
  - Risks with low frequency and high severity will have higher risk margins than risks with high frequency and low severity.
  - For similar risks, long duration contracts will have higher risk margins than those of shorter duration.
  - Risks with a wide probability distribution will have higher risk margins than those risks with a narrower distribution
  - To the extent that emerging experience reduces uncertainty, risk margins will decrease, and vice versa.

- **Calculation of Risk Margin**
- The Discussion Paper identifies a number of possible approaches to estimate risk margins, and does not advocate any one method. Possible considerations include:
  - Confidence levels (e.g. 75% probability of sufficiency)
  - Conditional tail expectation (Tail VaR)
  - Specified ranges
  - Cost of capital

Further Discussion Expected

- **May 2009**
  - Contract approach
  - Unearned premium approach
  - Margins: cost of bearing risk and subsequent measurements
  - Other comprehensive income
  - Non performance risk
  - Discount rates
- **June 2009**
  - Policyholder participation
  - Mutual companies
  - Inconsistencies with IAS 39 and IAS 18
  - Policyholder accounting – initial review
  - Policyholder participation
- **July 2009**
  - Conclusion on measurement approach
  - Participating, unit-linked and index-linked insurance contracts and investment contract and universal life contracts
  - Recognition and derecognizing
  - Definition and scope

Key Differences Between IFRS and US GAAP

Key Differences between IFRS and U.S. GAAP

Topic	Relevant IFRS Standards	Selected Differences from U.S. GAAP
Financial Instruments	IAS 39, Financial Instruments	• IFRS does not have a concept of other than temporary impairment. When there is objective evidence that a financial asset is impaired, an impairment loss must be calculated • Some impairment losses can be reversed • IFRS requires an investor to have significant influence over its investee in order to account for that investment under the equity-method, regardless of the legal formation of the investee. U.S. GAAP requires a partnership interest to be accounted for under the equity-method unless the investment is so minor that it has virtually no influence (less than 3% - 5%) • Unlike U.S. GAAP, an equity-method investee's accounting policies must be consistent with those of its investor • The definition of a derivative under IFRS differs from U.S. GAAP in that no net settlement is required • Like U.S. GAAP, derivatives embedded in host contracts generally are accounted for separately when their economic characteristics are not clearly and closely related to those of the host contract. However, given the different definition of derivative under IFRS, U.S. GAAP determinations regarding embedded derivatives should be revisited • The carrying amount of the host contract at initial recognition is the difference between the fair value of the hybrid instrument and the fair value of the embedded derivative • Under IFRS, an entity can designate a financial asset or liability, upon initial recognition, as at fair value through profit and loss only when it reduces an accounting mismatch, is managed on a fair value basis or is a contract that has a substantive embedded derivative • IFRS does not permit the short-cut method for hedge accounting • IAS 39 requires extensive financial statement disclosures regarding risk

Key Differences between IFRS and U.S. GAAP (Cont'd)

Topic	Relevant IFRS Standards	Selected Differences from U.S. GAAP
Pensions and Similar Obligations	IAS 19, Employee Benefits	• Like U.S. GAAP, assets must meet strict criteria to qualify as plan assets. However, under IFRS the assets must be unavailable to the entities creditors • Under IFRS, insurance policies must be issued by an unrelated party to meet the definition of plan assets • Unlike U.S. GAAP, the recognition of plan assets in excess of the defined benefit obligation are limited to available future benefits from the plan and unrecognized actuarial losses and prior service costs
Contingencies (Provisions)	IAS 37, Provisions, Contingent Assets and Contingent Liabilities	• Like U.S. GAAP, a provision is recognized for a legal or constructive obligation , arising from a past event, if it is probable and estimable • Under IFRS, probable means "more likely than not," which differs from "likely to occur" under U.S. GAAP • Under IFRS, a provision is recognized for a contract that is considered onerous (U.S. GAAP only has this concept in certain accounting standards) • Unlike U.S. GAAP, if there is a large population and a continuous range of equally possible outcomes, the obligation is measured at the midpoint of the range

Key Differences between IFRS and U.S. GAAP (Cont'd)

Topic	Relevant IFRS Standards	Selected Differences from U.S. GAAP
Share-based Compensation	IFRS 2, Shared-Based Payments	• Awards with graded-vesting are accounted for as separate awards under IFRS • Under IFRS, the grant date may occur subsequent to the service commencement date (U.S. GAAP only allows in certain circumstances) • Under IFRS, it is possible for the service commencement date to be before the award is approved • IFRS does not specifically address certain nonsubstantive vesting conditions
Real Estate and Property, Plant and Equipment	IAS 16, Property, Plant and Equipment IAS 40, Investment Property	• Unlike U.S. GAAP, when an item of PP&E comprises individual components for which different depreciation methods or rates are appropriate, each component is depreciated separately • Under IFRS, estimates of useful life, residual value and method of depreciation are reviewed at least annually and changes are accounted for prospectively as changes in estimate • IFRS allows PP&E to be revalued at fair value if fair value can be measured reliably

Key Differences between IFRS and U.S. GAAP (Cont'd)

Topic	Relevant IFRS Standards	Selected Differences from U.S. GAAP
Income Taxes	IAS 12, Income Taxes	• Deferred tax assets are recognized only when probable • Enacted or substantially enacted tax rates are used • Change in tax rates are recorded in P&L, unless it relates to equity • All deferred taxes are classified as non-current • There are no deferred taxes for differences related to initial recognition of assets/liabilities • Inter-company profits are calculated using buyer's tax rate • There is a one-year limit (with respect to next reporting period) on goodwill adjustment for current taxes related to a business combination; there is no time limit for deferred taxes not previously recognized • No deferred taxes are recognized for investments in subsidiaries, associates or joint ventures if: – The parent can control the timing of the reversal – It is probable that the related temporary difference will not reverse in the foreseeable future • Foreign non-monetary assets – deferred taxes are recognized for differences related to foreign non-monetary assets that are re-measured from local to functional currency