



# Implementing IFRS in the Insurance Industry

Observations and Lessons for the Future

ADVISORY

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# Foreword



Conversion to International Financial Reporting Standards (IFRS) has posed significant challenges for companies worldwide. To assess the effect of those challenges, KPMG sought the views of 47 insurers in a survey conducted in 2006. The survey aimed to determine the impact of conversion on accounting issues, financial reporting risks, and resourcing as well as to identify areas for post-IFRS implementation improvement for insurers.

The survey reflects the changing circumstances facing the industry. For example, in 2005 the International Accounting Standards Board (IASB) required insurers in many jurisdictions to adopt a new standard, "IFRS 4 Insurance Contracts" (Phase I of the IASB's insurance contracts project). The IASB introduced IFRS 4 to help insurers avoid the need for information systems changes during the short period of time between Phase I of the project and the introduction of Phase II, which will address accounting for insurance contracts.

Although the new interim standard generally permits insurers to continue their existing accounting policies for insurance contracts, "IFRS 4 Insurance Contracts" introduced some changes, which are reflected in the survey results. The most significant ones resulted from new disclosure requirements and the reclassification as investment contracts of those contracts that do not transfer significant risk. Additionally, insurance companies faced many challenges in implementing IAS 39 "Financial Instruments: Recognition and Measurement," IAS 32 "Financial Instruments: Disclosure and Presentation," and other standards in situations where some unique features in insurance contracts created difficulties in interpreting standards to provide meaningful results.

Given the limited changes in accounting for insurance contracts, it is understandable that the majority of the companies surveyed did not see many benefits of converting to IFRS. In parallel, the use of European Embedded Values (EEV) by life insurers becomes a key focus for analysts and users in certain countries, such as the United Kingdom, where IFRS results were often ignored. More companies are now supplementing IFRS results with EEV information. It will be interesting to see the future effects of IASB's IFRS Phase II on this development.

The IASB will publish a discussion paper as part of the IFRS Phase II insurance contracts project at the end of 2006. The proposals are likely to recommend substantial changes to insurance company accounting, but will also pose far greater challenges in converting systems and data as a result of a possible move toward fair- or current-value accounting. The Phase I experience should provide valuable guidance to companies in coping with the more significant Phase II challenges that lie ahead.

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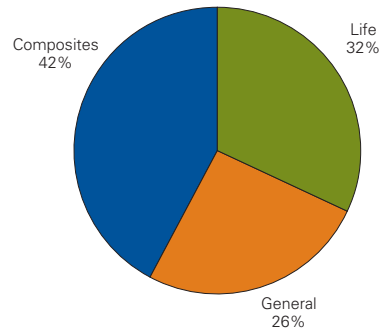
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# Survey Details

The survey sought the views of 47 insurers, including 15 representatives of life companies, 12 representatives of general companies, and 20 composites (companies whose business includes life, general, and/or health insurance).

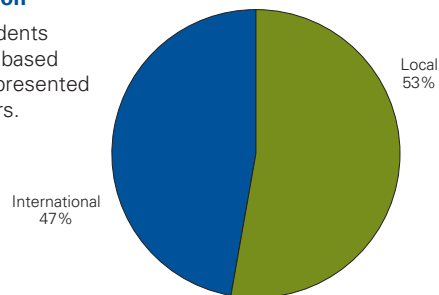
Respondents represented 17 countries: Australia, Austria, China, Czech Republic, Denmark, Finland, France, Germany, Italy, Netherlands, Norway, Philippines, Singapore, South Africa, Spain, the United States, and the United Kingdom.

## Sector



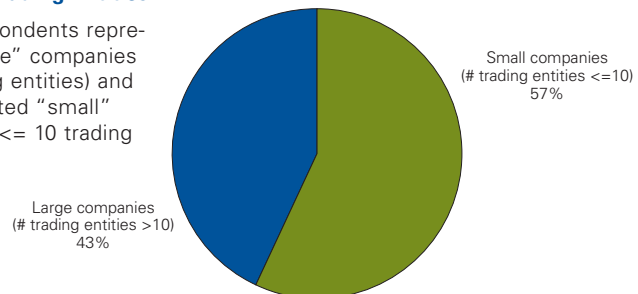
## Geographic Location

Twenty-five respondents represented locally based insurers, and 22 represented international insurers.



## Number of Trading Entities

Twenty respondents represented "large" companies (> 10 trading entities) and 27 represented "small" companies (<= 10 trading entities).



# Executive Summary



*"For a life company, external impact and impact on management information has been minimal. Analysts and management focus on embedded-value supplementary accounts. IFRS has been an uninteresting distraction."*

—International life company in the United Kingdom

## Key Findings

The survey data indicate that insurers have done considerable work to facilitate the IFRS conversion process. Although early indications are that companies feel they have derived few benefits from the effort, a number of issues still should be considered in planning for future reporting. These issues include:

- The majority of respondents noted that implementing IFRS has increased financial reporting risk. This result was mainly due to IFRS's technical complexities but also to factors such as organizations' reliance on manual workarounds using spreadsheets, management's distraction from business-as-usual, and the staff's lack of experience with the standard. Companies will need to ensure that enhancements to processes, systems, and controls are implemented to minimize the risk of financial reporting errors. The increased volume and complexity of reporting along with manual workarounds have put considerable pressure on staff, perhaps unsustainably so in certain cases.
- In addition, as the picture of better practices emerges from 2005 accounts, nearly half of the companies surveyed recognize that more work is required to enhance disclosures. With a number of companies leading the way with disclosures on sensitivities and risks, some useful information is emerging for capital markets and other users. This result is perhaps one key benefit of the disclosure requirements introduced by IFRS 4. Companies recognize the need to improve disclosures, and with advances being made in a number of jurisdictions in risk and capital management together with regulatory initiatives such as Solvency II, enhanced transparency is likely to result and be of value to users. (KPMG intends to publish a survey of the disclosures made in 2005 IFRS financial statements.)
- It may be helpful for companies to take a step away from viewing the financial statements from a compliance perspective and instead consider how best to explain and present the performance of the business and identify which measures and messages need to be communicated and how. These efforts should then guide the approach to the detailed production of the disclosures and the operating and financial review.
- A large number of respondents see the need to further embed IFRS into business processes and systems and to bring IFRS into "business as usual." Continuing to automate systems—particularly actuarial systems—to ensure accuracy and timeliness of financial reporting remains critical. About half of the life insurance companies surveyed have not fully embedded actuarial changes in core systems. On the other hand, over 80 percent of survey respondents state that they already have either fully or partially introduced new consolidation systems, which are critical to timely and accurate reporting for large international groups.
- No widely accepted benefits of implementing IFRS emerged clearly from the survey results. About a third of companies surveyed did cite transparency and comparability as major benefits of IFRS, but more companies cited major drawbacks to conversion. Key concerns included the complexity of presentation and disclosures as well as volatility of earnings. More than half of the companies surveyed are concerned about earnings volatility, and only a fifth of the companies surveyed believed that IFRS financial reporting gave them a better understanding of the business.

- International companies have had to increase resources and do more work than smaller, locally based companies. This finding reflects the complexity and differences in products sold internationally and the considerable guidance needed from head offices. In particular, companies and their auditors have had to spend a lot of time interpreting the principles-based standards. Specifying the data requirements for insurance disclosures and collating the data also proved to be time-consuming. In contrast, some of the small companies still have more work to do in embedding IFRS conversion into their systems.

The survey results highlight a number of important challenges facing insurance companies in both the short and the long term. In 2006, many companies intend to improve their disclosures as better practices emerge, and a number of improvements to processes remain outstanding. Longer term, the focus will be on implementing other new standards and the IFRS Insurance Contracts Phase II project.

## 2006 Priorities

### *Disclosure Requirements*

The survey shows that Phase I IFRS conversions have offered insurance companies few benefits; whether the new disclosure requirements introduced by IFRS 4 will ultimately provide increased transparency to capital markets (in a manner they value) remains to be seen. Disclosures have been one of the key challenges of the IFRS conversion, and nearly half of the companies surveyed have stated that they intend to improve on their disclosures. One of the difficulties faced by most companies was trying to determine how much detail needed to be included as well as the appropriate balance between qualitative and quantitative information. Many have commented that IFRS 4 may not have been particularly helpful, with high-level requirements in the standard but with considerably more detailed (non-mandatory) guidance included in the appendix.

It is worth noting that in certain jurisdictions, where improvements required by regulatory initiatives have been made in risk and capital management frameworks, some companies have found that management can gain valuable insights concerning risk profile, exposures, and sensitivities to key risks. In addition, the developments in the Solvency II initiative, the equivalent efforts from the International Association of Insurance Supervisors (IAIS), and ratings agencies all point to the insurance industry improving their risk and capital management frameworks. Disclosure of such information required by IFRS 4 and IFRS 7 (from 2007 at the latest) is likely to help organizations communicate more effectively to capital markets.

In 2006 companies will need to evaluate emerging better practices in disclosure. In addition, companies will need to consider the concurrent implementation of IFRS 7, which refines some of the disclosure requirements in IAS 32 and IFRS 4.

### *Technical Complexity*

Most survey respondents commented on the technical complexity of IFRS and increased risk in the financial reporting process. Complexity is particularly problematic—many companies cited the difficulties associated with the standards' technical intricacies. We believe these challenges will continue, primarily because they arise



from compliance with principles-based standards and the ongoing introduction of new and often complex standards. It is also possible that IFRS is perceived as complex because staff members lack experience with it. In addition, many insurance companies struggled with applying IFRS to transactions because the standards do not specifically address some of the different features of the insurance business.

A key consideration for companies is to ensure they have sufficient qualified resources who are able to advise on new and existing standards. Also important is continued training of all key finance and actuarial staff to ensure that knowledge continues to be consolidated as well as to help ensure that staff within the business understand the reporting implications of their work. Retaining staff who have acquired valuable technical knowledge is also critical.

#### **Outstanding Implementation Areas**

Many companies adopting IFRS for the first time found themselves working at a fast pace—if not a frantic pace—to produce their 2005 IFRS financial statements. The survey identified several areas where organizations could make improvements, including:

- Reducing reliance on manual workarounds
- Embedding the IFRS changes into business-as-usual activities
- Training staff on technical accounting matters
- Assessing ongoing resourcing requirements and the priorities of the finance function
- Redressing any imbalance between focus on compliance activities and performance efficiency

A first step in the process is to identify areas of improvement and produce an implementation plan. This effort should provide a focus for the key priorities and enable the finance function to take a measured and informed approach to ensure that 2006 and subsequent year-ends run smoothly.

While transitioning to Phase II, another key for insurers will be to identify a minimum number of improvements to produce reliable and robust information in a timely manner. Planning is essential to enable the finance function to cope with complex issues in a cost-effective manner and at the same time minimize and control financial reporting risks.

#### **Lesson for the Long Term**

##### **Conversion Approaches**

A number of groups may be planning to convert subsidiaries or recent acquisitions to IFRS. Some may intend to convert voluntarily to strive for competitive advantage; others may aspire to achieve better-practice standards or meet the requirements of frameworks such as Solvency II. The following points may be relevant in planning future conversions:

- Determine whether a systems-based conversion is likely to be more cost-efficient than manual workarounds over the long term. The decision on the approach adopted will need to take account of the status of the IT environment, availability of resources, stability of the reporting framework with the changes being introduced by the IASB, and the timing of the Phase II standard for insurance contracts.

*“Expect the unexpected. Despite covering all issues, [the] detail in [the] standard was not fully understood until completing accounts.”*

—International insurer in Australia

- Undertake an early comprehensive impact-and-scoping analysis to identify key accounting and disclosure changes, system changes, and business impacts.
- Assess adequacy of resources, including training requirements, at an early stage of the conversion process.
- Ensure involvement of actuaries from the outset of the project.
- “Front-end” the work on the disclosure requirements in the project plan to avoid last-minute requests for data from subsidiaries.
- Ensure that the head office has adequate resources to coordinate and provide support for overseas entities.
- Ensure early and ongoing engagement with auditors and advisers to help ensure prompt identification and resolution of accounting issues.

#### ***Implications for Planning for Phase II***

Phase II is expected to introduce a significantly greater level of complexity and scale of change than Phase I. The current indications are that the IASB will adopt a prospective current exit value model (possibly very close to a fair value model) to account for insurance contracts. This requirement is likely to call for major systems changes and additional data collection to run the valuation models. It will thus call for a strong emphasis on early project planning and highlights the need for systems-based conversion, data availability, and adequate resources. In addition, the timing of the Phase II work will be difficult to gauge because it is not yet known when the final standard will be implemented.

Some companies have already started to consider some of Phase II’s potential accounting and business impacts, including their alignment with other projects such as Solvency II. What is clear at this stage is that many believe that, at a minimum, a two-year transitional period will be required after the publication of the standard. The need to collect new data and make complex systems changes, together with potential restatement of the comparatives, means that careful consideration will be needed both by the standard setters (on the length of the transitional period) and by insurance companies (on when to start their conversion projects).

One of the lessons from Phase I was that many unforeseen issues arose when companies tried to implement a standard that did not accommodate the intricacies of different insurance contracts. When the discussion paper is produced, companies need to assess Phase II’s potential implications and interpretation for their products so they can inform the IASB of any issues. Such an effort will help enable companies to avoid unforeseen complexities and delays in the conversion process.

# Survey Results



*“The problems that cause the most effort are not the most obvious, for example expanded consolidation requirements.”*

–International insurer in the United Kingdom

## Technical Accounting Challenges

As expected, complying with the insurance-related disclosure requirement was one of the top challenges for respondents (Figure 1). It was a new, highly complex requirement that called for careful planning, data gathering, and use of judgment, because most insurers’ existing systems could not easily produce the required information. A number of international companies experienced significant difficulties in obtaining information for the new disclosure requirements in a consistent manner, and in gauging materiality where aggregation was required.

The survey also highlights the dichotomy between the disclosure requirements being viewed as too complex by many companies but also seen by many as a key focus area for improvement in 2006. Many companies recognize the need to enhance disclosures based on best practice, but they also see the need to reflect on how to present relevant information in a way that is helpful to the users. We expect users will increasingly request information for comparative analysis.

Respondents’ other top challenges occurred in the areas of financial instruments, several technical insurance-related issues, and taxation (including deferred taxes). Many respondents had to make changes to their financial instruments accounting, specifically by moving from cost- to fair-value and hedge accounting and by preparing the required disclosures. The difficulties companies experienced reflect the complexity of IAS 39 and IAS 32. In our experience, the consolidation of special-purpose entities (SIC 12), particularly investment funds, also raised significant technical and systems and processes challenges for insurance companies.

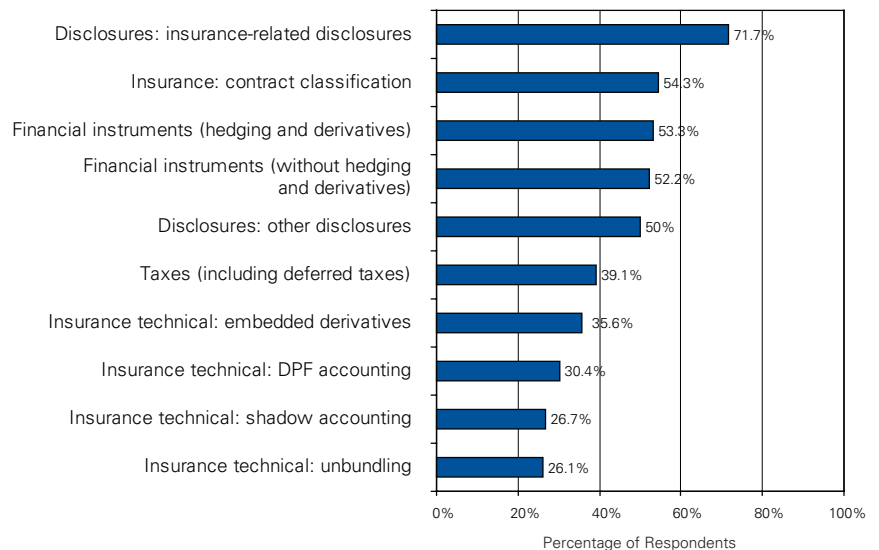
In addition, IFRS 4 introduced a new definition of insurance contracts that required companies to review the contract classification of the entire insurance contract portfolio. The accounting for contracts that needed to be reclassified as investment contracts changed significantly. Apart from the initial lack of clarity and agreement internationally on the technical issues of how to calculate and amortize deferred acquisition costs and front-end fees, this effort was a key reason why many life insurers encountered significant challenges in the IFRS conversion process. The ranking of “technical accounting challenges” varies according to the insurer’s local environment, so that it is not surprising that composite and international insurers, which had to deal with multiple jurisdictions, generally had greater difficulties in the areas of disclosures, financial instruments accounting, and insurance contract classification.

While 54 percent of all respondents cited “contract classification” as one of the most challenging areas, 74 percent of international companies found this area to be challenging. This effort proved in practice to be more complex than expected due to the variety of products offered internationally, especially by life companies.

Many companies often experienced greater difficulties in applying other standards to insurance businesses because when those standards were developed they did not take into account some of the different features of insurance products. This message does not emerge clearly from the survey, but the experience of KPMG member firm professionals shows that many more difficulties were encountered from a broad range

of standards, such as IAS 27 “Consolidated and Separate Financial Statements,” IAS 19 “Employee Benefits,” and IAS 18 “Revenue.” The resolution of some of these issues took longer than others because in some cases it was not immediately clear how standards could be interpreted or whether the interpretation would give meaningful results.

**Figure 1: What accounting issues areas have been the most challenging within your IFRS conversion?**



Source: KPMG LLP (U.K.), 2006

### Impact on Financial Reporting Risk

Two thirds of respondents indicated that the introduction of IFRS had increased risk in the financial reporting process (Figure 2). What’s more, almost 75 percent of respondents indicated that the increased risk is a result of the increased complexity of technical issues (Figure 3). As IFRS is embedded into systems and processes, manual workarounds (and the extent to which they can distract from business as usual) remain a considerable risk in the post-implementation environment for both life and non-life companies—although the former perceive a greater risk in these areas. The risk of unfamiliarity with the numbers correlates with the size of the company and mirrors the higher complexity of the conversion for those insurers. In the current regulatory environment, companies will need robust plans (e.g., allowing adequate time and using the appropriate processes for review) and controls to prevent errors in reporting.

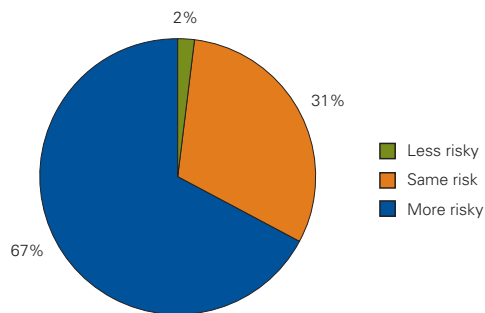
Some respondents said they completed the increased work associated with conversion using the same levels of resources. What remains to be seen is whether companies that saw risks going up but performed the conversion without adding resources have in place an effective control environment to manage the complexities of the conversion—or whether controls will also change in response. In an environment of increased complexity and risk, companies will likely need to enhance controls and resources to be able to cope effectively with new complexities. Training and building

knowledge among managers and staff will become increasingly important. These circumstances would hold particularly true for life companies, which are likely to perceive a higher level of risk due to the complexity of their products.

In addition, half of respondents commented that increased resources had increased risk as companies were not able to train those staff or had used temporary staff. About a third of the companies are concerned about the underlying quality of information, perhaps derived from non-core financial systems.

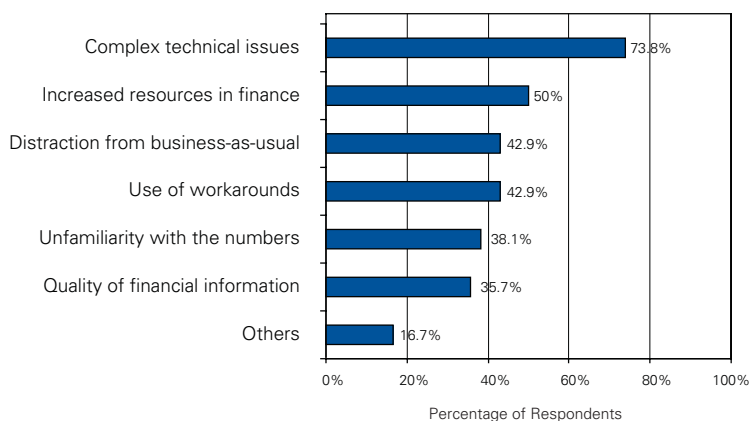
All this shows that IFRS conversion is not a one-time effort but requires careful ongoing assessment of related implications for financial reporting risk.

**Figure 2: To what extent has the implementation of IFRS affected risk in the financial reporting process?**



Source: KPMG LLP (U.K.), 2006

**Figure 3: How has risk been affected?**



Source: KPMG LLP (U.K.), 2006

### Embedding IFRS Changes

A system-embedded conversion emerged as the preferred practice—especially for general ledger and consolidation systems—since the majority of the respondents stated that IFRS is fully embedded in core systems and processes in these areas. It seems that insurers have achieved conversion to fulfill compliance requirements, but they have not fully addressed potential performance improvement issues (that is, process efficiencies or other business benefits that can result from the knowledge developed during conversion). Thus embedding IFRS into business-as-usual, and making general improvements regarding systems and processes, remains an area for future development. In addition, more than two thirds of the respondents stated that “rationalizing processes” is a core improvement they plan to undertake in 2006. Such efforts may include, for example, systems solutions for investment contracts accounting, consolidation of mutual funds, and data collection for insurance disclosures.

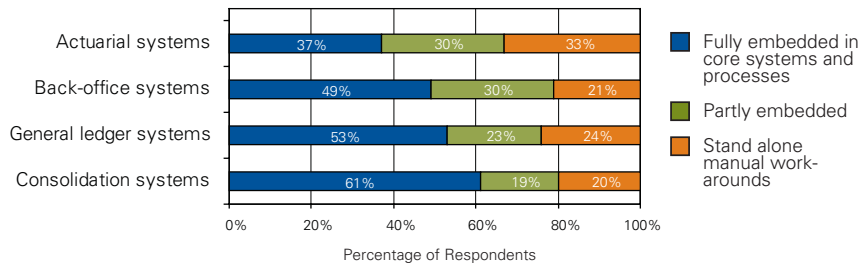
Across all respondents, the results showed that the embedding of IFRS in actuarial systems is limited. Large and international respondents, especially, indicated a higher ranking of stand-alone manual workarounds for actuarial systems, probably because their aggregated figures are produced with less systems support than occurs within other companies.

Many actuarial departments remain under significant pressure not only to implement IFRS but also to cope with numerous regulatory and financial reporting requirements (such as EEV) as well as risk and capital management responsibilities. Life insurance actuaries have had to cope with investment contract accounting as well as produce information to comply with the disclosure requirements. They have had to make quick fixes, often in the form of manual workarounds, to produce restated income statement and balance sheet information for investment contracts. Overall it is not surprising that almost 70 percent of respondents indicated that embedding IFRS into business-as-usual practices remains a challenge.

Companies will need to address whether their systems are capable of dealing with disclosure requirements and contract classification on an ongoing basis. Embedding IFRS into processes and IT systems will help insurers account for changes and requirements more easily than has been the case for many companies that have performed the conversion. As insurers make enhancements to their (financial) reporting environment, they will need to ensure that they are able to anticipate future changes in technical requirements that will require flexibility in systems, processes, and resources.



**Figure 4: Are IFRS changes well embedded in finance processes or have you largely implemented tactical workarounds to meet deadlines?**

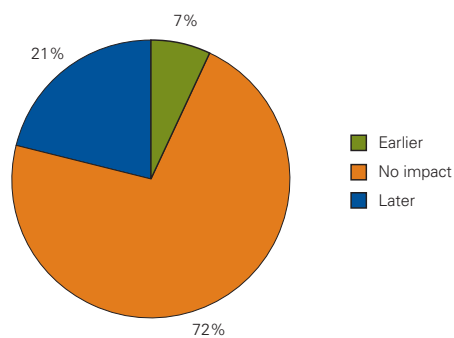


Source: KPMG LLP (U.K.), 2006

### Impact of Announcement of Preliminary Full-Year Results

In general, the IFRS conversion did not affect the timing of companies' announcement of preliminary financial results (Figure 5). Almost 80 percent said they were able to release IFRS results either earlier than or at the same time as they had released local GAAP results the previous year. Moreover, most of those that released results later did so within two weeks of the previous year's release date. It has been a difficult year-end for many companies and their auditors. There has been enormous pressure on the staff to meet the reporting timetable—perhaps one of the reasons for increased risks as a number of workarounds were adopted.

**Figure 5: What impact will IFRS have on the timing of announcement of preliminary full-year results?**



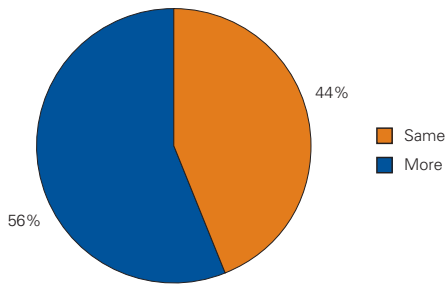
Source: KPMG LLP (U.K.), 2006

### Impact on Staffing Levels

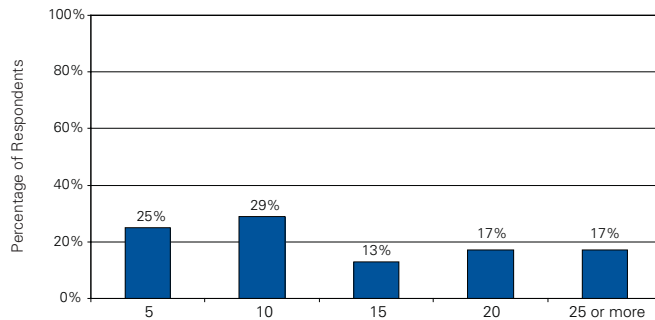
IFRS conversion has had a staff cost. On average, about half of all respondents that increased staffing levels increased resources by less than 10 percent; the other half by more than 10 percent. The biggest increases occurred at large and international companies—about two thirds of the large insurers, the composites, and the international respondents increased staff in the actuarial and finance functions. Sixty percent of life insurers have not increased staff, but they face additional work in embedding actuarial system changes. Many life companies have tended to adopt workarounds to implement the changes for accounting for investment contracts. In coping with complex standards and considerable change, smaller companies tend to absorb the implementation effort within the existing staff. Nonetheless, IFRS conversion is a resource-intensive effort, and we expect continuing demand for staff with the technical expertise to cope with changing standards.

**Figure 6: To what extent has IFRS affected business-as-usual staffing levels in the finance and actuarial functions?**

Amount of resources needed



For those requiring additional resources, percentage of change

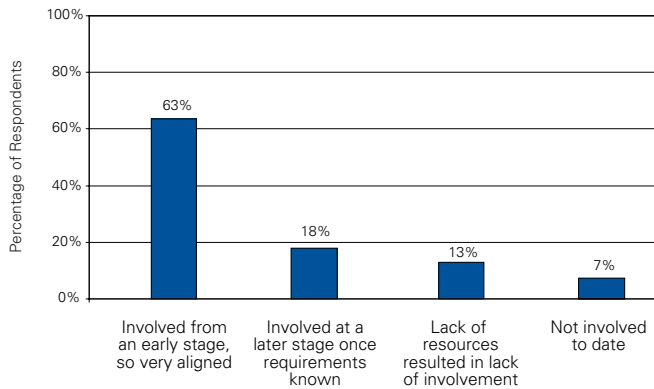


Source: KPMG LLP (U.K.), 2006

### Alignment of Actuarial Function

The need for actuarial resources in the conversion effort has been important, particularly for life insurers. A significant proportion of companies involved actuaries at an early stage of the conversion process (Figure 7). For about a quarter of the non-life companies, the lack of actuarial involvement was due to the lack of resources; about 17 percent of these companies did not involve actuaries in the conversion process.

Actuarial resources will be critical in implementing Phase II requirements and embedding those requirements into systems and processes. Ensuring early involvement of the actuarial function as well as a sufficient number of these resources will be critical for successful conversions.

**Figure 7: How well was the actuarial function aligned with the IFRS implementation?**

Source: KPMG LLP (U.K.), 2006

### Benefits of Implementing IFRS

Although none of the listed benefits were cited by a wide majority of all respondents, “transparency” and “comparability” were cited by more than a third of them as the major benefits of conversion (Figure 8).

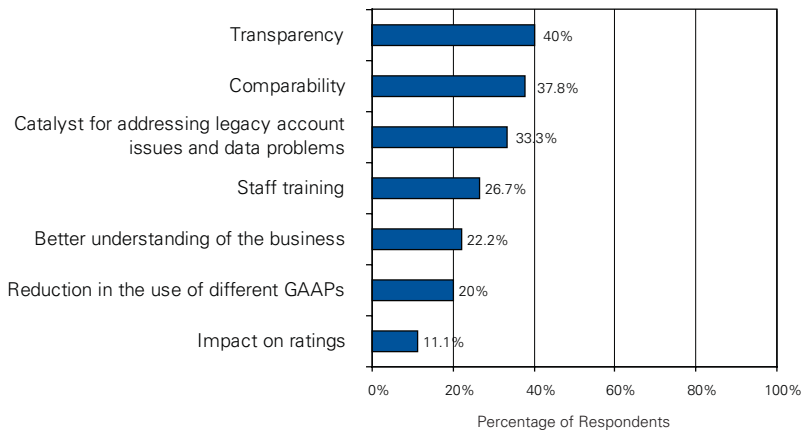
Additional benefits usually come with transparency and comparability. One of the key goals of IFRS 4 was to increase transparency—through, for example, additional disclosure requirements. The results show that transparency goals have been achieved only partially, perhaps because it will take time for companies to implement all the IFRS 4 disclosure requirements and for better practices to emerge. Also, because IFRS 4 permits the use of existing practices based on local GAAP for insurance accounting, companies cannot easily compare results internationally. Phase II addresses this issue by providing a single standard for measurement of insurance liabilities. Time will tell whether financial markets perceive (and reward) the increased transparency in insurance company financial reporting.

Internal benefits can be obtained from high-quality management information, which will improve the understanding of the business thereby facilitating better decision making. As there are no significant improvements to insurance accounting, it appears that many companies have not obtained better financial information for decision making. However, 40 percent of the respondents feel that transparency has increased and therefore it is possible that some of the disclosure requirements, such as sensitivity analysis, may have brought some internal and external benefits.

Although conversion benefits are generally ranked low, one third of all respondents stated that a major benefit of the IFRS conversion was its value as a catalyst for addressing legacy accounting issues and data problems. Life insurers saw this opportunity as a top benefit, along with “staff training.”

*“The resources requirements and technical complexity far exceed expectation. [We] must prepare early and put in [a] huge amount of accounting and actuarial resources.”*

—Local insurer in China

**Figure 8: What do you believe will be the major benefits for you of implementing IFRS?**

Source: KPMG LLP (U.K.), 2006

### Drawbacks of Implementing IFRS

“Complexity of presentation and disclosures” was the major drawback cited by all respondents (Figure 9). The issue of complexity is particularly challenging for life companies: 93 percent of these respondents cited it as a major drawback. The significant increase in disclosure requirements, the difficulty in gathering data, the lengthy accounts, the questions about clarity, and the need for judgment as well as the logistical problems many companies faced in performing the conversion internationally—all these concerns add up to questions about the long-term value of the required information. This finding prompts questions about whether companies are concerned that the detail required is, in fact, excessive or whether further consideration is required by companies on how to present relevant information more concisely.

In addition, “earnings volatility,” which is discussed in the next section, was noted by the majority of respondents as a further major drawback to introducing IFRS.

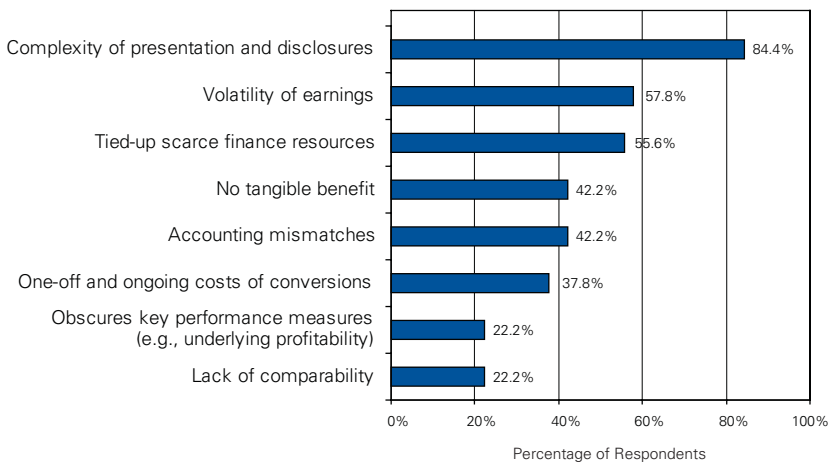
Overall, organizations have committed considerable time and money, but they are not convinced that they have derived significant benefits from the investment of converting to IFRS. Indeed, more than half of all respondents note that they have had to tie up scarce resources for what was largely perceived to be a compliance effort. There could be a number of reasons why companies have not seen benefits from the introduction of IFRS. For example:

- Many organizations grappling to understand the implications arising from the conversion have not considered how the resulting information may be useful for internal management reporting. In some cases implementation of IFRS has yielded counterintuitive results, which, from management’s perspective, do not reflect economic reality. Other changes have introduced unnecessary complexity, including consolidation of mutual funds, which might not help the users of the accounts.

- Continued use of local GAAP in subsidiaries or supplementary information such as embedded values may mean that IFRS information is not widely used for decision making purposes or by users of financial statements.
- No significant improvements in accounting practices have been made with respect to insurance contract business.

With the number of concerns highlighted, we hope the IASB addresses these issues in the Phase II project and when amending other standards. Improvements in accounting for insurance contracts and other standards—such as consolidation, foreign exchange, and deferred taxes—should be considered in the Phase II project. Unless the proposals for Phase II overcome many of the concerns noted above, it is possible that alternative performance measures such as European Embedded Values will gain more prominence.

**Figure 9: What do you see as the most likely drawbacks to implementing IFRS?**



Source: KPMG LLP (U.K.), 2006

### Effects on Results Volatility

A number of the national GAAPs that preceded IFRS permitted or required the use of historical cost measures for assets and liabilities, which are intrinsically less volatile than the fair-value measures required by a number of standards under IFRS. Earnings volatility was therefore widely predicted by commentators and preparers prior to the introduction of the new standards. The survey has largely reflected this prediction. Many companies' concerns about volatility arise from accounting, as opposed to economic, mismatches.

Insurance companies' financial statements may exhibit higher volatility under IFRS than under previous accounting policies for a number of reasons, including the measurement of financial instruments (including derivatives and embedded derivatives) at fair value, the measurement of defined benefit pension schemes at current value, and the de-recognition of equalization and catastrophe provisions. In particular the increased use of fair-value accounting (IAS 39) might create "artificial volatility." In some instances, the introduction of IFRS has yielded counterintuitive results (e.g., the elimination of treasury shares held by life funds).

Insurance companies have been able to mitigate a certain amount of the volatility arising from measuring financial assets at fair value by selecting suitable accounting policies for insurance contracts and the matching of financial assets and liabilities to help minimize the potential accounting mismatches. Some companies have chosen to account for their financial assets as available-for-sale. This policy requires the assets to be measured at fair value, with the unrealized fair-value gains and losses being recognized in equity rather than income.

Other approaches refer to the designation of parts of the financial instruments as "loans and receivables," which allows for a subsequent measurement of those instruments at amortized cost, which might be close to the existing measurement under previous local GAAP. Other companies, typically those using current assumptions to measure insurance contract liabilities, might choose to measure their financial assets at fair value through profit or loss, so that the movements in gains and losses on the assets recognized in income are to some extent offset by equivalent movements in liabilities. In this case, there should be no accounting volatility arising for accounting mismatches, but where there are economic mismatches, they will be reflected in earnings.

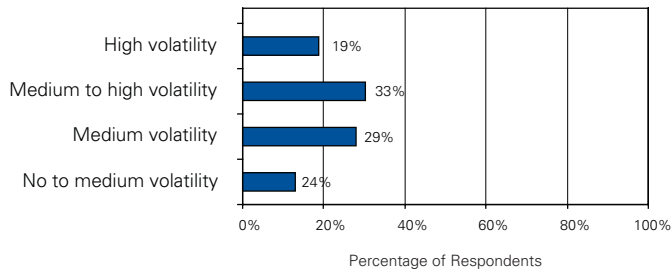
Other approaches to help minimize accounting mismatches include the use of hedging (and hedge accounting) strategies, shadow accounting, or other options available in IFRS 4 intended to make improvements to insurance accounting policies. These possibilities include discounting the liabilities using current interest rates rather than original interest rates.

What are the implications of increased volatility? First, it will be interesting to see how insurers and the markets respond to increases in reported volatility of results. Management may consider that the additional cost associated with improving the economic matching of assets and liabilities is a worthwhile expense if it leads to a less volatile result.

Second, management will need to ensure that internal reporting processes (including those for budgeting and forecasting) properly capture the increase in volatility to support management decisions. An analysis of the drivers of volatility in the business will be an important tool in managing results as well as communicating them in financial statements.



**Figure 10: What effect do you expect IFRS to have on the volatility of your results?**



Source: KPMG LLP (U.K.), 2006

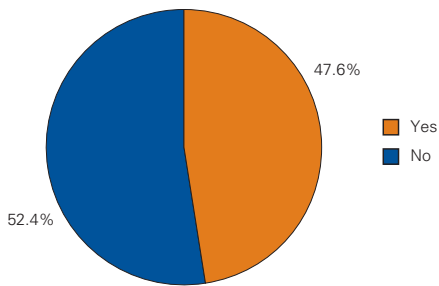
### Outstanding Post-IFRS Implementation Areas and Potential Improvement Areas

Complying with other standards while making IFRS business-as-usual remains a key challenge for more than half of respondents who had not finished the conversion. For now, respondents indicate that IFRS conversion is a compliance challenge, not a business or performance improvement opportunity. The challenges they continue to face, and plans for improvement, show that the adoption of IFRS is still evolving.

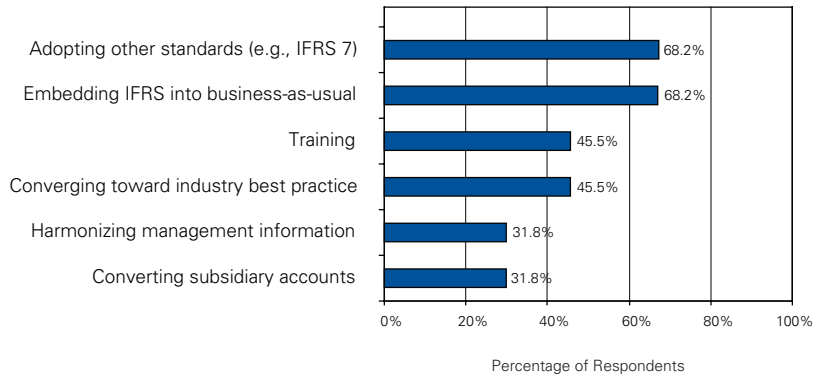
Harmonizing reported information to management information (under IFRS and other standards) remains a low priority as the industry is not yet convinced of the value of the accounting under Phase I. Thus, IFRS is primarily used for financial reporting purposes, but companies that recently converted tend to continue to manage the business based on local GAAP or other measures such as embedded-value accounting. Whether the introduction of Phase II will increase the harmonization of internal and external information remains to be seen. About a third of the respondents indicated their intention to convert their subsidiaries to IFRS, which will assist in the harmonization process as local GAAP is phased out.

Companies need to make sure their systems produce timely and accurate information under IFRS. As in the effort to manage earnings volatility, planning is also important in coping with ongoing challenges. Companies are headed in this direction: almost 60 percent intend to rely on a “dedicated team of experts” to address frequently changing, highly complex standards. This finding helps explain why respondents identified training as an outstanding area that nearly half of them plan to address in 2006 (Figure 11), and it aligns with perceptions of the complexity of the standards (Figure 6). In summary, the implementation of IFRS requires a considerable change management effort, particularly in training financial staff and enhancing non-financial staff’s understanding of the reported numbers.

**Figure 11: Will you have completed your IFRS project when you publish your 2006 accounts?**



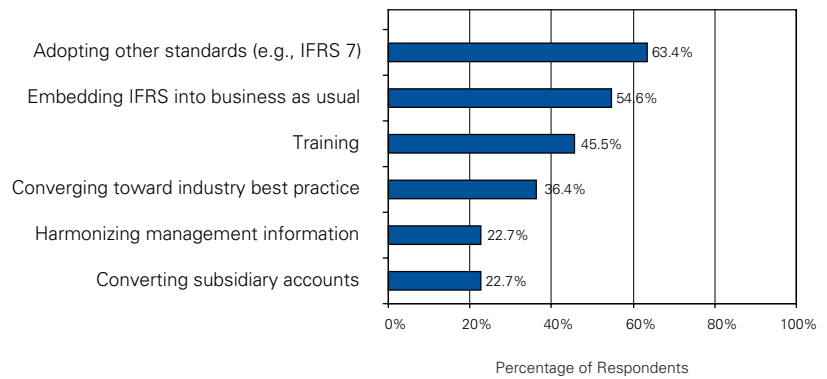
*If no, what areas will be outstanding?*



Source: KPMG LLP (U.K.), 2006

Some companies are seeking to address a number of these challenges in the coming year (Figure 12). Two thirds see as a key priority the adoption of other standards and embedding IFRS into business-as-usual practices; converging toward industry best practice is also considered important.

**Figure 12: Of those areas you indicated were outstanding, which will you address in 2006?**



Source: KPMG LLP (U.K.), 2006

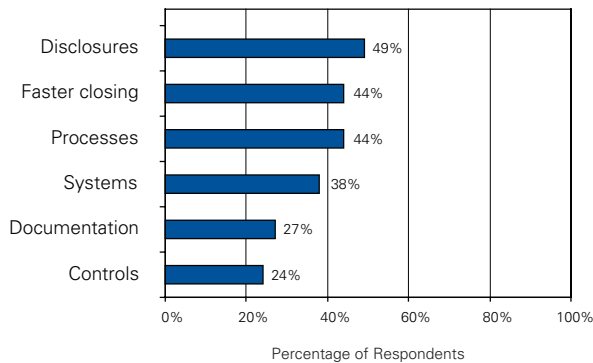
Many companies are considering making a number of improvements. Interestingly, although most companies reported on time this year, nearly half are considering how to close their books more quickly (Figure 13), which may be to give more time to senior management for review and analysis of the results. In addition, a quarter of respondents were seeking to address gaps in the documentation of new processes and controls, including enhancements to their accounting and reporting manuals.

Many finance functions are considering how they should be organized in order to maximize the value they deliver to the business. The complexity of IFRS and implementations experience has highlighted the need for more emphasis and focus on these areas. Most companies will need to develop an infrastructure and plans to implement such change. A structured assessment and prioritization of areas for improvement would be a reasonable next step.

*“Regular internal updates through monthly technical calls and periodic technical training sessions.”*

—International insurer in the United Kingdom

**Figure 13: Where do you think improvements could be made in relation to your IFRS implementation?**



Source: KPMG LLP (U.K.), 2006



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