

INSURANCE

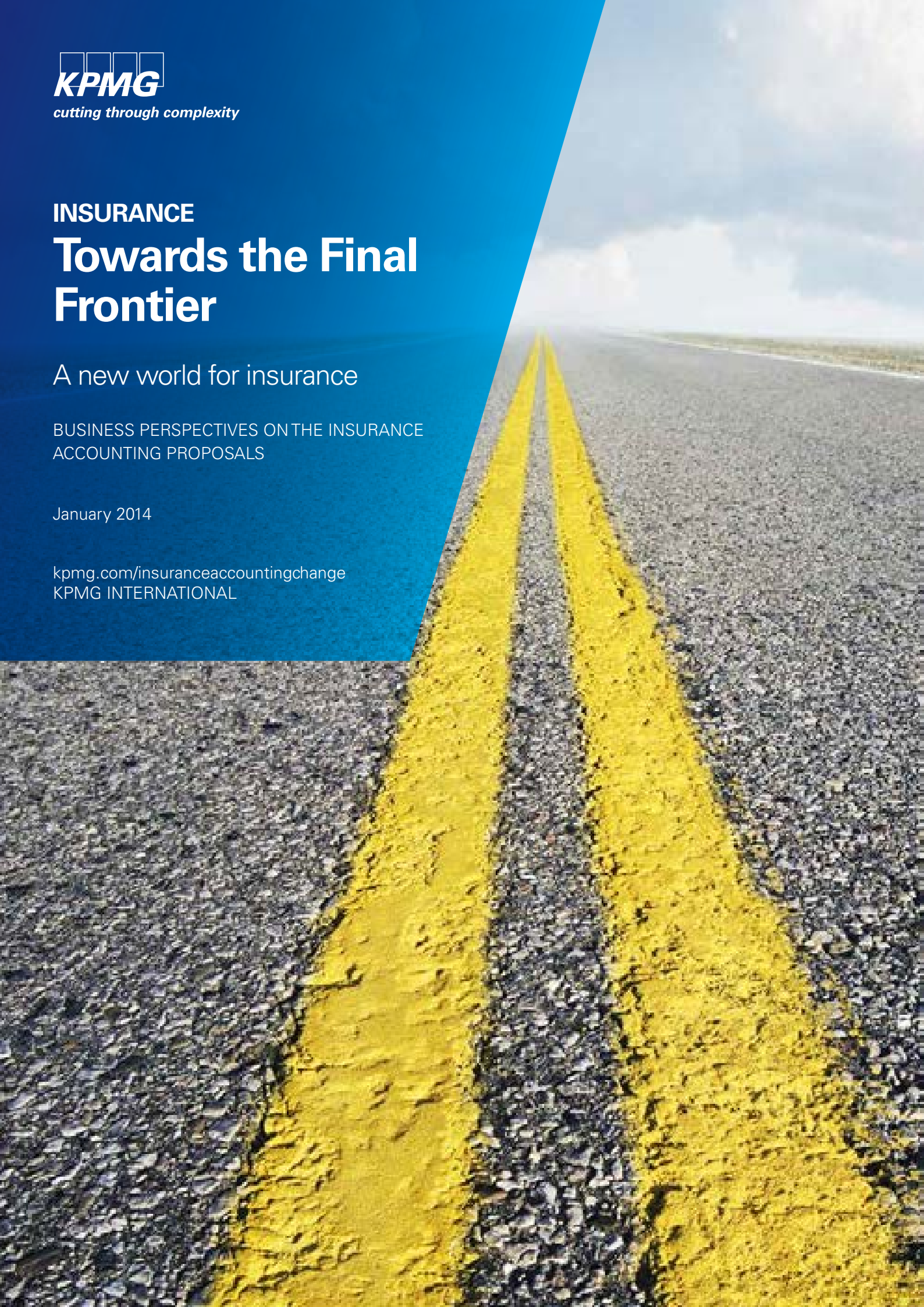
# Towards the Final Frontier

A new world for insurance

BUSINESS PERSPECTIVES ON THE INSURANCE  
ACCOUNTING PROPOSALS

January 2014

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How KPMG can help

Throughout the publication we:

- Present a high-level guide to the key **accounting changes**, including the measurement model, volatility, financial instruments accounting and asset-liability management.
- Consider the potential changes to **systems and processes**, such as changes to modeling and administration systems, as well as systems used to collect and aggregate data for disclosure. The new financial reporting changes and quantitative disclosure aspects of regulatory changes are likely to trigger the need for increased modeling capability, in terms of both IT and actuarial resource.
- Outline the **people and change** impacts. Insurers may need increased resources to manage the change but also need to consider how their resource needs will differ post-transition when compared with today. Responding to this shift will require effective change management.
- Discuss the broader **business impacts** and why the changes may affect the types of products that an insurer sells, the investments that it holds, executive compensation arrangements and how insurers communicate to the market.
- Address how an insurer brings everything together through a coordinated approach to **program management**. We consider what insurers should be doing now ahead of a final standard.

# The frontier to a new world for insurance

KPMG welcomes the progress towards implementing a more common framework for insurance reporting derived from significant International Accounting Standards Board (IASB) and Financial Accounting Standards Board (FASB) collaboration. Having greater transparency is long overdue for both the industry and investors alike. We believe the new accounting models are a step forward in better reflecting an insurer's underlying risks and liabilities — albeit with more volatility in the results. The financial impacts will need to be explained to analysts, investors and other stakeholders; this will be more challenging against a backdrop of wider accounting and regulatory change.

There have been many different views on the proposals, and getting executives to take notice may continue to be a challenge until the standards are finalized. There are still a number of understandable concerns being voiced within the comment letters, such as those surrounding the proposals relating to contracts with participating features, as well as the presentation of insurance revenue

and expense within the statement of profit or loss and the mandatory use of Other Comprehensive Income (OCI). Until these are resolved, there is the danger that the C-suite will put their focus elsewhere and perhaps not fully consider what the business impacts might be, resulting in potential missed opportunities or unnecessary costs being incurred.

In 2014, we believe the focus needs to shift from debating the 'perfect solution' to addressing practical considerations and ironing out unintended consequences. The result will be a 'frontier to a new world for insurance' — one with new financial reporting requirements and fresh challenges. Even though the new standards' effective dates are likely to be no earlier than 2018, insurers need to start thinking about the changes now. Operationalizing the technical aspects will need to start in earnest, especially where the implications require a significant ramping-up of finance and actuarial resources.

In this publication we examine the most important business implications

for executives to consider, including impacts on asset-liability management, profit profiles and product offerings. We also outline the potential technology impacts, as we continue to see many insurers tackling their legacy systems and working to future-proof systems with a life span beyond a 2018 effective date.

We have considered the implications of the current proposals, which are still subject to change. To help with your understanding, we have highlighted some of the areas that we believe are the prime candidates for further revision based on our review of key stakeholders' comment letters.

Throughout the document we focus on the primary *'things you need to know'* and overlay these with practical KPMG insights.

Insurers will feel the consequences throughout their organizations and the scale of change should not be underestimated. As always the devil will be in the detail, but the answer often lies in taking a strategic view.



**Gary Reader**  
Global Head of Insurance



**Louis Mannello**  
Global Insurance Accounting Change Leader



**Joachim Kölschbach**  
Global IFRS Insurance Leader

# More than just an accounting change

At KPMG we believe that insurers should view changes in accounting standards as far more than an accounting exercise. The impacts on the business, systems and people are often more pervasive than people think. In this publication we consider the overall impact of the proposals and

demonstrate that the considerations should not just be the domain of accounting professionals. Ultimately we believe this is a board-level issue.

Following the publication of the new proposals, a group of KPMG Partners met to discuss their perspectives. We have captured the discussion below.

These Partners have been listening to their clients' feedback on the proposals and helping them navigate the impacts. Throughout this publication we examine what executives 'need to know' — the following viewpoints provide a starting point on the subjects that really matter.

**Simon Perry:** Actual earnings could change under the current proposals and profits may be recognized later for certain products. The new guidance is also likely to increase earnings volatility. Communicating this to the markets is never an easy task.

**Mary Trussell:** Up until now insurance accounting has been so opaque it has been difficult to work out whether or not some products offer good value for money. The proposals have been criticized for their complexity but, with the right analysis, they could offer some much needed transparency.

**Danny Clark:** Insurers may have concerns over how they report new business. There's a question as to

whether or not insurers will continue with supplementary measures like embedded value reporting. While there was hope that the proposals would reduce the number of metrics, I can't see that happening for a while. In any case, some may effectively have to produce two sets of metrics, alongside a clear reconciliation. This could be compounded if insurers are also reporting under Solvency II, where there are currently differences between the proposed standards.

**Mark McMorrow:** It's also important to remember that accounting revisions for financial instruments are coming up and need to be planned for — with or without an insurance standard.

**Laura Hay:** The whole issue of external stakeholder management can't be overlooked. Insurers will need to explain the impact of the standards on earning patterns in a way that doesn't increase complexity or cause shareholder confusion. Even changes in presentation could, if not managed effectively, give the impression that insurance is a less attractive industry to invest in.

**Danny Clark:** Certain products may no longer look so attractive. For instance long-duration insurance with guarantees will likely give rise to more volatile

results. Similarly, growing businesses may see a less positive impact on results if earning patterns become more back-ended.

**Laura Hay:** And in turn the product profile, pricing and mix could shift. Insurers may start to reconsider what they sell and how they sell it. This could impact distribution channels. It can be a challenge for an insurer to become more customer-centric when the customer propositions are, to a certain extent, influenced by the accounting policies.



►► Harmonized accounting standards will introduce greater consistency between and within insurance groups, which will make production and managing the business that much easier and cheaper in the longer term. It should also help investors compare the relative performance of the insurers they invest in and should make cross border mergers and acquisitions much easier.

**Mary Trussell**, Partner, KPMG in the UK

**Mary Trussell:** My best guess is that these proposals will be effective in about 4 to 5 years time. Most accounting and actuarial systems have a time horizon greater than this, so if insurers are contemplating transformational change or even embarking on upgrading ledger systems or their modeling capability, they really need to be addressing this in their plans.

**Simon Perry:** How insurers calibrate the relative importance of the accounting numbers against other metrics will differ between territories. In Europe, Solvency II will likely be a large driver of products. Many insurers have invested vast amounts of resources developing their systems and processes and, ideally, we expect to see that investment pay off and be used to drive the production of the IFRS results.

**Mark McMorrow:** We see life insurers' infrastructure set up to value their business using locked-in assumptions, with their actuarial production cycle focused on periodically testing liabilities for adequacy. The proposals are based on updating estimates at the end of each reporting period. Insurers will need to iterate multiple runs. That's a hugely different process and a whole new world for the actuaries. As a result, I'd expect some insurers may need to upgrade their modeling capability considerably.

**Simon Perry:** Although the proposals are subject to redeliberation, I believe the industry has a broad idea where things are going to line up. So it's possible to build in that flexibility and future-proofing now.

**Gary Reader:** Many insurers are waiting until there is a final standard before launching a detailed assessment of the reporting and business impacts, although some companies are concerned about the amount of work to be performed in a three-year transition period. But that shouldn't stop insurers from having a high level view of the main effects. I think they'll need to incorporate where this is currently heading within their strategic decision making.

**Louis Mannello:** Don't ignore the people aspects. Insurers are likely to require significant resources from what is, still, a

limited talent pool. This means nurturing existing talent now and potentially reallocating workloads so specialists such as actuaries can focus on the things only they can do.

**Gary Reader:** Getting executives to take notice can be a challenge until the standards are final. There are still a number of understandable concerns being voiced within the comment letters. Until these concerns are resolved, an air of skepticism will likely linger over when we will reach a final standard. Without a final standard, the C-suite may continue to focus on bigger and more urgent issues.

**Gary Reader** is KPMG's Global Head of Insurance

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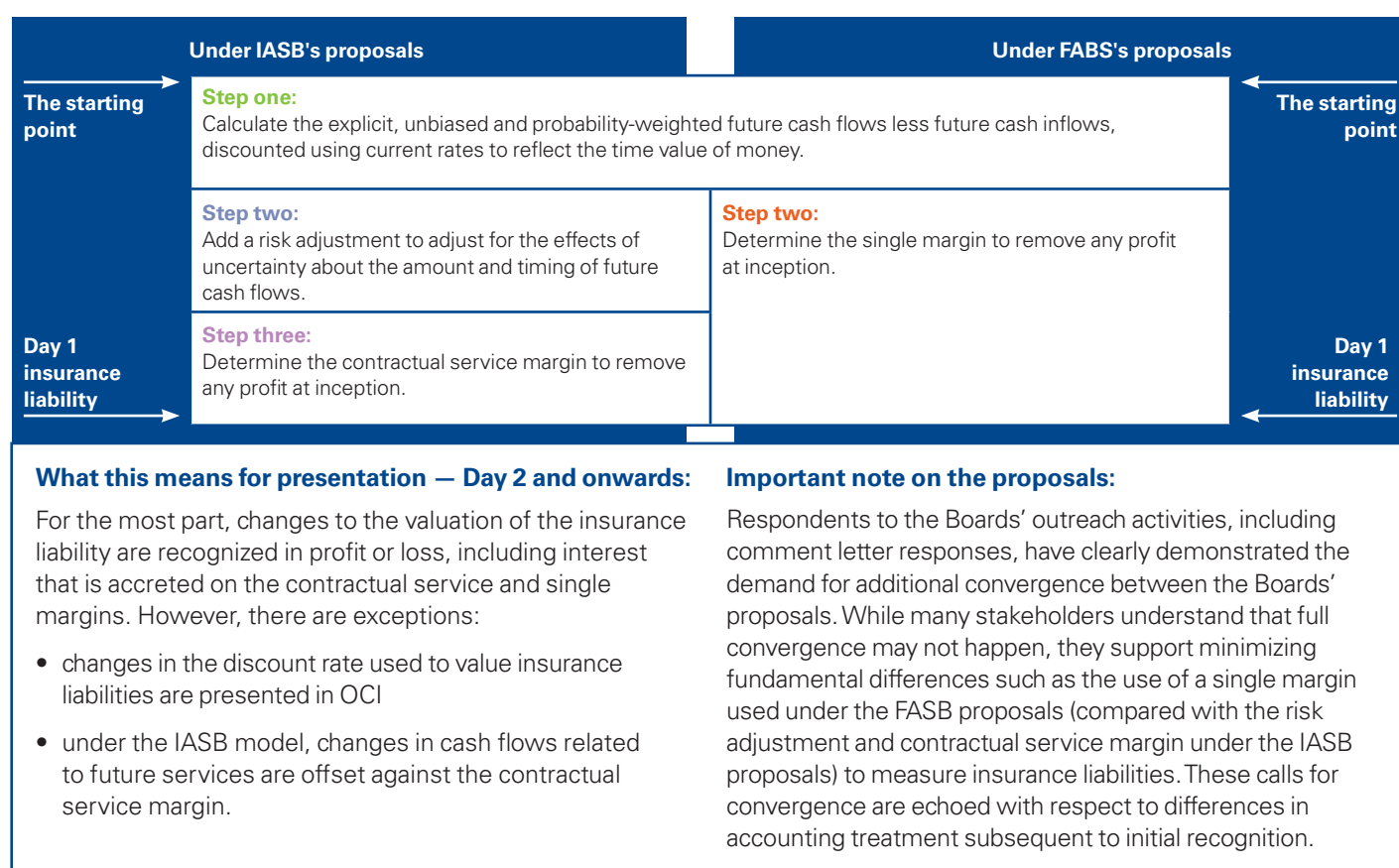
**Danny Clark** leads the Insurance Accounting Change initiative in the UK

**Simon Perry** is an Actuarial Partner in KPMG in the UK's practice



# Accounting and reporting impacts

## The measurement model



## The things you need to know

- 1) The proposed measurement model is based on a current fulfillment value that incorporates all of the available information in a way that is consistent with observable market information. An insurer will be required to update estimates of its insurance liabilities each reporting period using current market-consistent information.
- 2) The proposals apply to all issued contracts that meet the definition of an insurance contract. However, there are differences in scope between the IASB's and FASB's proposals — e.g. investment contracts with a discretionary participation feature (DPF) issued by insurers are within the scope of the IASB's proposal, but not the FASB's proposals.
- 3) The proposals segregate the effects of underwriting performance, which are reported through profit or loss, from the effects on the measurement of insurance liabilities arising from changes in discount rates, which are presented in OCI.
- 4) The proposed 'mirroring approach' aims to reduce accounting mismatches by aligning both the measurement of contracts whose cash flows vary with underlying items that the insurer is required to hold with the measurement of those underlying items. Examples include participating, with-profits or unit-linked contracts.
- 5) There will be a new presentation for the statement of profit or loss and OCI. Insurance contract revenue will be disconnected from the premiums received, but based on the initial expected pattern of claims and benefits, revised to reflect revisions in estimates and actual experience.

►► The proposed standards will have a defining impact on what insurers report, how they report it and how they ultimately present their business to the outside world. This could be revolutionary, not evolutionary.

**Louis Mannello**, Global Insurance Accounting  
Change Leader

6) The contractual service margin and single margin will eliminate any gains at contract inception. Unlike the FASB's single margin, the IASB's contractual service margin will be adjusted for changes in estimates of future cash flows related to future coverage and other future services.

7) A simplified premium-allocation approach is available for contracts (mostly short duration) that meet

certain conditions. This approach allocates premiums over the coverage period in a way that best reflects the transfer of services.

8) The proposals do not prescribe a specific method for determining the discount rate. A top-down approach or bottom-up approach may be used to determine an appropriate discount rate. In theory, both approaches should result in the same

discount rate. However, differences are expected in practice and some stakeholders have provided alternative approaches for the Boards to consider as part of the comment letter process.

9) The proposals introduce extensive disclosure requirements. The volume and complexity of disclosures will likely increase. Preparers' ability to produce timely financial reporting may also be impacted.

## ►► KPMG observations

- While many stakeholders support the Boards' recognition of feedback received through previous outreach activities, comments on the current proposals show that areas of concern continue to exist and provide insight into which specific aspects of the proposals may be subject to reconsideration. Some areas of concern highlighted by stakeholders include:
  - presentation of the statement of profit or loss and OCI
  - mandatory use of OCI for presenting changes in the discount rate
  - the proposals relating to contracts with participating features, including the 'mirroring approach'
  - for the FASB, not permitting the 'unlocking' of the single margin for changes in estimates of future fulfillment cash flows.
- The challenges of retrospective application should not be underestimated. While practical expedients address the impracticability of full retrospective application, determining the margin and the amount accumulated in OCI at the date of transition will still be complex and time-consuming.
- Transition may prove particularly challenging where a number of years are required to be presented in accordance with financial or regulatory reporting requirements. For example, IAS 1 *Presentation of Financial Statements* requires the presentation of a third statement of financial position at the beginning of the earliest comparative period if the application has a material effect on the information being presented.



## Volatility

► The new guidance is likely to increase earnings volatility and communicating this to the markets is never an easy task.

**Simon Perry**, Actuarial Partner, KPMG in the UK

### The things you need to know

- 1) Volatility in results generally arises through economic or accounting mismatches. An economic mismatch arises when the values and ultimate cash flows of insurers' assets and liabilities respond differently to changes in economic conditions. An accounting mismatch arises when there are different measurement bases for assets and liabilities or differences in the presentation of related gains and losses.
- 2) An insurer's profit or loss and equity may yet become more volatile, by using current estimates of cash flows, where assumptions, including the discount rate, are revisited each reporting period rather than 'locked in' under a historical cost basis.
- 3) For insurers with participating business, the introduction of a 'mirroring approach' may result in significant changes from current practice for some entities. For example:
  - a) the requirement to decompose cash flows from participating business into three separate sets of cash flows and account for them separately, e.g. application of different discount rates;
  - b) where the 'mirroring approach' does not apply because the participating contract does not specify a link between the underlying items that the insurer is required to hold, e.g. universal life and index-linked contracts. These contracts will be measured using the general measurement model with updated discount rates used to develop profit and loss;
  - c) where the 'mirroring approach' applies, insurers may face an additional element of volatility as changes in the value of any underlying option or guarantee in the contracts will be presented in profit or loss;
- d) the shareholders' portion of any unallocated surplus will not be recognized as a liability.
- 4) Certain aspects of the proposals, together with the proposed revisions to accounting for financial instruments, may reduce volatility in profit or loss. For example:
  - a) The effect of changes in discount rates on the measurement of an insurer's liabilities and some of its financial assets will be presented in OCI.
  - b) The discount rate determined at the insurance contract's inception will be used for calculating interest expense in profit or loss with the aim of producing an amortized cost-based profit or loss result.





c) A measurement exception for insurers with participating contracts permits the measurement of amounts directly linked to underlying items to

'mirror' the measurement of the underlying items.

d) Under the IASB proposals, the contractual service margin will be

adjusted in future periods for changes in estimates of future cash flows that relate to future coverage or services.

## ►► KPMG observations

- Many stakeholders asked the Boards to reconsider proposals relating to contracts with participating features and indicated the current proposals are difficult to understand and to apply consistently. For example:
  - Many insurers find it difficult to determine if a contract qualifies for the 'mirroring approach' or believe the scope is too narrowly defined.
  - The decomposition of cash flows from participating contracts is operationally complex and it is not always clear how that decomposition has to be done under the proposals.
  - Operational challenges are anticipated relating to determining the discount rate.
- Many stakeholders believe the presentation of changes in the value of options and guarantees is inconsistent depending on whether an insurance contract qualifies for the 'mirroring approach' (i.e. changes are presented in profit or loss) or does not qualify (i.e. changes are presented consistent with the building block approach in either profit or loss, OCI or as an adjustment to the contractual service margin).
- The requirement to present the effect of changes in discount rates within OCI has been highlighted within a number of comment letters as an area of concern as it may lead to accounting mismatches. The creation of accounting mismatches will depend on how corresponding financial assets are classified under the relevant financial instruments standard (e.g. financial assets being classified as fair value through profit or loss (FVTPL) or amortized cost, rather than as fair value through OCI (FVOCI) under IFRS 9 *Financial Instruments*). Earnings and equity will be more volatile where the measurement of insurance liabilities and the measurement of the assets that an insurer holds to back those liabilities respond in different ways to changes in interest rates.
- Insurers will want to identify gaps between their current and future data requirements and assess the capability of their current systems to supply the information they need. Some insurers have expressed concern about the need to hold both current and historical data to track discount rates determined at inception of the contract and at the end of each reporting period. This information will be required to calculate differences in the valuation of insurance liabilities attributable to changes in those rates, and to present those differences in OCI. This is more than just a data issue — the need to keep track of two sets of discount rates makes the close process more complex.
- Insurers will need to evaluate how best to explain the impact of market value movements on their results as they investigate how to manage increased volatility if the proposals are implemented in their current form.

# Financial instruments accounting and asset-liability management



► It's also important to remember that accounting revisions for financial instruments are coming up and need to be planned for — with or without an insurance standard.

**Mark McMorrow**, Insurance Accounting Change Leader, KPMG in the US

## The things you need to know

- 1) The IASB is working to replace IAS 39 *Financial Instruments: Recognition and Measurement* with IFRS 9 *Financial Instruments* and plans to finalize most of the remaining aspects by mid-2014. These include:
  - a) Classification and measurement of financial assets and financial liabilities
  - b) Impairment methodology, using a 'three-bucket impairment model'
  - c) Hedge accounting — the general hedging proposals are finalized while a discussion paper on macro hedging is expected in early 2014.
- 2) Similarly, the FASB is updating existing guidance on financial instruments. These proposals are also under deliberation with final documents addressing classification and measurement as well as impairment expected in the first half of 2014. However, no formal timeline to finalization has been released for the FASB's hedging proposals.
- 3) The classification of financial assets will assume greater significance in future years as insurers are required to adopt new standards on financial instruments. The degree of reported volatility in profit or loss will depend heavily on how financial assets are classified and measured. The insurance proposals may reduce volatility in profit or loss by presenting the effect of changes in discount rates on the valuation of insurance liabilities in OCI. However, accounting mismatches may be created for insurers holding assets in a fair value business model, derivatives to hedge insurance liabilities or debt instruments that fail to qualify for FVOCI classification.
- 4) Volatility will arise when assets are sold, even for insurers that hold all their assets in a business model that allows FVOCI classification, e.g. bond investment portfolios managed both in order to collect contractual cash flows and for sale.
 

This is because the accumulated gain or loss on the financial asset will be presented in profit or loss at the time of the sale, while the cumulative effect of any changes in the discount rate on the insurance liability will remain in OCI until the insurance liability is derecognized.
- 5) Both proposals provide an opportunity to redesignate some financial assets on initial application of the new standards. Careful consideration is particularly important:
  - a) Under the IASB's transitional provisions, which permit only a limited ability to redesignate some financial assets
  - b) When classifying assets under the financial instruments standards if these are applied before the new insurance standards.



6) If the effective dates for financial instruments and insurance contract standards differ, insurers will need to:

- a) work through two major programs of accounting change
- b) classify their financial assets in accordance with the new financial instruments standards before they have fully analyzed

the effect of the new insurance contracts standard

c) consider any implications on asset-liability management before the insurance proposals are implemented.

7) If an insurer measures its assets at FVOCI, unmatched durations and differences in credit spreads will

still give rise to volatility. However, this volatility will be presented in OCI rather than profit or loss — and investors are likely to want transparent disclosure to see the impact.

## ► KPMG observations

- Whether insurers re-evaluate their asset-liability management strategies or investment allocations, they may be highly dependent on the financial instruments standards. Where they choose to re-evaluate, they will need to consider:
  - The consequences for investment yields. For example, where non-life insurers shift to assets with shorter durations to achieve closer matching of assets and liabilities, they may, as a consequence, experience lower ongoing investment yields.
  - Asset designations upon transition to a new financial instruments standard. This will include reviewing their approach to hedging and projected financial performance in a variety of different scenarios reflecting different economic circumstances.
- A clear message has been sent to the Boards about insurers' support for aligning the effective dates of the insurance contracts and financial instruments standards. An alignment of effective dates will mean insurers may avoid undertaking two separate programs of change and will improve users' ability to compare financial results over time. However, if alignment is not achievable, stakeholders are encouraging the Boards to include clear and specific guidance on the redesignation of financial assets on adoption.
- Tentative decisions made by the FASB in December 2013 may add additional complexity to some insurers' accounting change programs. These tentative decisions indicate that convergence with IFRS no longer seems probable on either the impairment or the classification and measurement proposals.
- Insurers have been particularly concerned about using derivatives to hedge interest rates where hedge accounting is not achieved. This is because changes in the value of derivatives will be recognized in profit or loss with no offset for changes in the measurement of the insurance liability. Many insurers will be following the IASB's project on macro hedging to see whether this may provide them with a solution beyond what may be in the final insurance standard — a discussion paper is expected in Q1 2014.

# Considerations for systems and processes

## The things you need to know

- 1) The changes required by the proposals will undoubtedly have a significant impact on the insurance technology landscape. The greatest impacts are expected to be on actuarial modeling and valuation systems as well as financial reporting systems.
- 2) Insurers may be challenged by simultaneous system changes, for example, those changes relating to the revision of financial instruments accounting or regulatory changes, such as Solvency II in Europe, CROSS in China, Solvency Modernization Initiative in the US, etc. Developing an appropriate implementation plan may avoid two successive rounds of substantial changes if timing differs from the finalized insurance standard.
- 3) Many insurers may need to support multiple reporting platforms (i.e. local statutory, IFRS, US GAAP, internal reporting). As a result, many insurers may be dependent on an intricate web of legacy systems and, therefore, significant or extended closing processes. Transition planning will need to customize the enterprise's resource planning systems.

### Impact on systems and processes:

We have provided an indicative assessment on the scale of impact on the key insurance systems and processes.

● Significant change    
 ● Moderate change    
 ● Minor change    
 ● Low impact expected

Topic	Systems impact							Processes impact									
	Modeling capability	Data requirements	Modifications/redesign	Interfaces and mapping	Capacity and run times	Chart of accounts	Reporting	Product development	Channel management	Sales	Underwriting	Customer services/policy admin	Claims management and benefits	Investment operations	Financial reporting	Actuarial	Reinsurance
Building block one — fulfillment cash flows	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Building block two — discount rate	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Building block three — risk adjustment	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Building block four — margin	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Recognition and contract boundaries	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Acquisition costs	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Premium-allocation approach	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Reinsurance	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Unbundling	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Presentation	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●
Transition	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●	●



►► The biggest issue for some insurers is designing their actuarial valuation systems to come up with a measurement in accordance with these proposals.

**Louis Mannello**, Global Insurance Accounting  
Change Leader

4) Performing 'high-level' gap analysis may reveal areas where important data is not available from existing processes and systems. The gap analysis could include trialing data

sources and analyzing their ability to draw on models and methodologies for the purposes of the proposals.

5) Developing a common understanding of the proposals' impact will involve

many different functions within the organization. This includes client-facing functions and processes, as well as the back office. Clear and open communication with IT will be vital.

#### ►► KPMG observations

- IT costs could easily make up the majority of the overall transition costs. History — not least the experience of the 2005 transition to IFRS by European listed insurers — tells us that addressing change late is costly. Many insurers that made extensive use of inefficient work-arounds or spreadsheets ultimately chose to undergo major transformation projects after implementation.
- The message being sent by many stakeholders encourages the Boards, wherever possible, to consider areas where complexity can be reduced. However, current proposals include a significant amount of additional complexities in financial reporting that will need to be considered in designing systems, e.g. use of OCI, unlocking the contractual service margin, transition, and presentation of the statement of profit or loss and OCI.
- The proposals are likely to have a significant impact on closing processes and reporting timetables. If implemented in their current form, the proposals will require significantly greater use of actuarial techniques calibrated using market observable data as at the reporting date and extensive disclosures. Without significant forward planning and reengineering, speed in releasing results may be constrained by limited modeling capacity and/or lengthy run times.
- Upgrading actuarial modeling capabilities is expected to be expensive, but can be a worthwhile investment with wider benefits. For example, those insurers upgrading their systems in preparation for Solvency II are investing heavily in upgrading their modeling capability and governance, identifying data sources and refining reserving methodologies. In addition, insurers may need to invest heavily in systems, particularly in building data warehouses. The cost may be lower for insurers headquartered in countries that already have actuarial valuations and financial reporting based on current assumptions such as Canada, Australia and the UK, or for those European insurers who have prepared their systems to comply with the requirements of Solvency II.
- Investing in automating accounting systems and financial processes can have a major impact on the ability to forecast and communicate results with confidence, and free up resources to focus on financial analysis rather than generating the numbers. An integrated change program may facilitate compliance with the new insurance model and reap the benefits of standardization in terms of cost reduction and greater efficiency.
- Many insurers have been holding off on initiating any system changes until the proposals are fully evolved with a final standard in sight. However, some insurers have begun an initial impact assessment for systems and processes, if only at a high level.
- Whenever insurers make changes to their systems and processes, it is important to consider the impact on the system of internal controls. These changes can also provide an opportunity to improve the quality of the control frameworks over areas such as reliable financial reporting, operational effectiveness and regulatory compliance.



# Impacts on people and change

## The things you need to know

- 1) Resourcing and education will be vitally important to the implementation. As a result, insurers should begin to formulate their specific resource and education needs for implementing a new insurance standard. Whereas the FASB has yet to decide on the length of the implementation period, the IASB has indicated it will allow approximately three years between the final standard and the effective date. Accordingly, we expect a likely effective date of either January 1 2018 or 2019 for the IFRS standard.
- 2) The proposals are expected to place a heavy demand on experienced actuarial, finance and IT resources. Even if actuarial and accounting resources are sufficient to meet the demands of the proposals, transition may divert skilled resources away from other business priorities. Some insurers may find themselves outsourcing routine actuarial work.
- 3) A wide group will require training, including accountants, actuaries, tax, IT, HR, senior management and investor relations. Some insurers may already have started raising awareness outside the inner circle of technical subject matter experts. Training and education will need to address initial transition and, once the proposals become business as usual, staff will need to learn how to operate new systems and processes.
- 4) Resource needs will likely peak during the transition, particularly while staff investigate the impacts of the proposals, perform trial runs and report under existing reporting frameworks while parallel running the proposals. Insurers addressing regulatory changes, such as Solvency II, will need to address resource conflicts. Post-transition resourcing requirements will need to reflect business as usual in the new reporting environment.

### ►► KPMG observations

- The success or failure of the transition largely depends on how effectively a company informs, mobilizes and educates their people. The establishment of a core team, with senior management support, can help to set the stage for a successful transition. Changing processes and procedures also requires people to adapt and develop new skills.
- For some insurers, the implementation of the new global insurance model may be a catalyst for a variety of enhancements to the finance function, including shared services, outsourcing, co-sourcing, off-shoring and automation.
- Do not underestimate the magnitude of change for people when moving from a familiar GAAP, in particular during the transition period when reporting under two bases. Understanding the 'bridge' between the old and new reporting bases is the key to making the proposals more familiar. Leaving people considerations to the last minute risks a disengaged workforce.



► It will be important to consider the people implications that will come from the changes. Insurers are likely to require significant resources from what is still a limited talent pool. This means nurturing talent now.

**Louis Mannello**, Global Insurance Accounting Change Leader

# Business implications

## Performance reporting

### The things you need to know

- 1) Traditional key performance indicators (KPIs) may change significantly under the current proposals, especially for life insurers with more of the indicators derived from sources other than the chart of accounts.
- 2) Insurers may initially continue to report and use traditional measures, such as 'combined ratios', with a disconnect between performance measurement and management reporting; however, in the long run, more decision-useful metrics are likely to be developed using information reported under the finalized standards.
- 3) Disclosures and explanation of both the amounts and the movements in OCI are expected to significantly increase as compared to current reporting.

#### ►► KPMG observations

- A key area for further consideration by the Boards is whether presenting insurance contract revenues and expenses in profit or loss based on the current proposals will provide the information that users consider most relevant. While the new presentation approach is aligned conceptually with the gross presentation in profit or loss in the revenue recognition proposals, feedback received from many stakeholders encourages further consideration by the Boards. Some stakeholders have commented that the volume and depth of the proposed disclosures is sufficiently overwhelming to compromise their usefulness to financial statement users.
- Continuing to report historical KPIs would increase the financial reporting burden if the final standard lacks disclosures relevant to traditional performance measures. In this case, insurers may need to identify new KPIs. There has not been a consistent view as to what metrics are wanted by users, and it is not clear whether traditional measures or more of an 'earnings' analysis, as contemplated in the proposals, are needed.
- The proposed aggregation and disaggregation principles for disclosures may make segment reporting more important, which allows a presentation through the 'eyes of management' but with a reduction in comparability.
- Performance-related executive compensation metrics may need to change or insurers will have to continue reporting traditional metrics, at least internally, which may not be aligned with externally reported performance.
- Multiple reporting bases may be required for a number of reasons. Firstly, insurers may find it necessary to maintain both the 'old and new' basis of accounting during the transition period. Secondly, it is possible that the previous basis may be required to meet local requirements for local GAAP financial reporting, statutory filings, taxation or regulatory purposes. During this period, insurers will need to track and reconcile the differences between a variety of different reporting bases. Even if parallel processes are introduced, insurers may have less time to analyze their results. Companies may face a longer close calendar.
- Overall, increased disclosure requirements may make pricing and profitability information more visible. Depending on the disclosure requirements contained within the final standards, insurers may need to consider the implications of disclosing highly granular, proprietary information to an external audience.
- The proposals should improve the consistency of the reporting between entities that issue insurance contracts and other financial institutions, as well as financial conglomerates with significant non-insurance operations. This is because many existing insurance accounting practices may not best meet the objectives of general purpose financial statements.



► Switching reporting bases can result in very different patterns, which could influence how attractive the business looks.

**Mary Trussell**, Partner, KPMG in the UK



## Product strategy and design

- It can be a challenge for an insurer to become more customer-centric when the customer propositions are, to a certain extent, influenced by the accounting policies.

**Laura Hay**, Partner, KPMG in the US

### The things you need to know

- 1) Increased earnings volatility resulting from the proposed measurement model may prove unattractive to investors and those participating policyholders who may share in earnings. As a result:
  - a) There may be a shift in focus towards more traditional protection products, such as term life products, and away from longer-term life products with embedded guarantees, such as certain universal life products, life products with guaranteed minimum death benefits, deferred annuities, variable annuities and some participating products
  - b) Products that lock in guaranteed interest rates or investment returns may only become available for shorter durations to reduce interest rate exposures.
- 2) For non-life products, particularly for long-tailed casualty lines of business, the change in discounting methodology is likely to change the timing of profits. This includes longer-term liability insurance or workers' compensation insurance.
- 3) More extensive disclosure requirements may cause product pricing and contract margins to become more transparent and result in increased competitive pressure. These include requirements to reconcile the opening and closing balances of contractual service margin or single margin.





### ►► KPMG observations

- Many insurers will review their product portfolio to determine the profit signature of their products under the proposals and identify sources of volatility stemming from the use of current information. These reviews are particularly relevant for long-term products and insurers may respond by adjusting product design.
- As the cost of risk becomes more transparent under future reporting, investors are likely to start distinguishing between businesses with lower returns and those that provide high returns but with more capital intensive products and an assumed greater risk. There is likely to be sharper distinction between savings and protection products with fewer products that blend protection and savings.
- Where life insurers continue to hedge some of the risks of balance sheet volatility by hedging the cost of guarantees to underpin their capital position, releases from prudent margins will be replaced by releases from the contractual service margin and the risk adjustment or the single margin.
- Profits on risk products, such as payout annuities and term life products, are generally earned as the risk expires, providing a relatively smooth trend of earnings which is not correlated with financial markets.
- Insurers may test impacts on overall risk adjusted metrics and consider the accounting and risk implications of decisions over product offerings, distribution strategies and allocation of capital.
- Insurers may consider restructuring their reinsurance programs. Certain financial reinsurance products will become less desirable because insurance liabilities will be discounted under the proposals. This may result in a shift towards traditional reinsurance products with significant risk transfer.



## Stakeholder and capital management

► Insurers will need to explain the impact of the standards on earning patterns in a way that doesn't increase complexity or cause shareholder confusion.

**Laura Hay**, Partner, KPMG in the US

### The things you need to know

- 1) Understanding the impact on distributable profits is an important issue, this includes dividend payments to both shareholders and policyholders.
  - a) Whether profits will emerge more slowly or more quickly will depend heavily on each jurisdiction's current GAAP.
- 2) Profits recognized under the proposals are expected to emerge differently than under current accounting.
  - b) Profit emergence will likely vary depending on the type of product. For example, many property and casualty contract liabilities are not discounted today under current GAAP. For these contracts, discounting will accelerate profit recognition; however, the inclusion of a risk adjustment will have an offsetting effect.
  - c) Profit emergence is expected to vary for the same contract under the IASB's and the FASB's measurement models. For life contracts, the differences may not be as significant since the coverage and settlement periods are often closely aligned.



## ►► KPMG observations

- Analysts and shareholders are expected to require a lengthy period of familiarization with how the proposals will affect reported results and, where applicable, how the proposals affect dividend policy. Some insurers have already begun to hold discussions with analysts to educate them on the impact of the proposals on their company. Once investors and analysts become familiar with the new reporting bases, it may be easier for them to compare the insurance sector with other industries.
- Volatility in earnings and/or equity will have a direct impact on reported GAAP or IFRS capital. In some jurisdictions, such as Canada, general purpose financial statements are used for regulatory reporting and volatility in shareholders' equity has a direct effect on regulatory capital. Greater capital volatility has been brought into sharp focus in the context of deliberations on Pillar 1 of Solvency II and the increased use of measures of economic capital.
- Many insurers are concerned that under the proposals they may face a competitive disadvantage when it comes to raising capital because their profits will be more volatile, which may have a significant impact on investor benchmarks, for example, price-earnings multiples.
- It will be important to ensure that information used by analysts is easy to find because presentation may change and disclosures will be new. Insurers will need to consider preparing a detailed pack for analysts mapping out how to find the information they require to build their models, and holding analyst training sessions.
- Finding the right balance of how to aggregate disclosures will be key. Too much information will likely lead to overload and may be commercially detrimental, while too little information may make the financial statements opaque.

# Program management

# Bringing it all together

## The things you need to know

- 1) Many insurers are already considering the implications of the proposals for their business, even though there are many moving parts that still need to fall into place before we see a clear outcome. This is particularly relevant for insurers that are currently addressing the challenges of Solvency II. Taken together with the proposals, there are opportunities for synergies in areas such as modeling capability and investment in systems.
- 2) An effective date of the new IFRS insurance standards for reporting periods beginning either on or after January 1 2018 or 2019 is most likely, assuming the potential publication of a final standard in early to mid-2015.
- The FASB has yet to decide on a time frame for effectiveness after its standard is finalized.
- 3) We would like to see the effective date of the proposed insurance standards and financial instruments standards align because a misalignment has the potential to require two major programs of change.
- In November 2013, the IASB tentatively decided that the mandatory effective date of IFRS 9 would be no earlier than 1 January 2017. Following the IASB's decision and the views of many preparers that they will require three years to implement its proposed impairment requirements, it is possible that the effective dates of IFRS 9 and a new insurance standard might come into alignment. The IASB has stated that it will consider the interaction of the effective date of the insurance proposals with the mandatory effective date of IFRS 9 before it issues the final insurance standard.
- 4) Insurers will need time for implementation. The timeline (see page 21) includes time for insurers to run systems under their existing GAAP and the proposals in parallel, i.e. dual running, and refine numbers so that they can understand the impact of the changes on their business.

### ►► KPMG observations

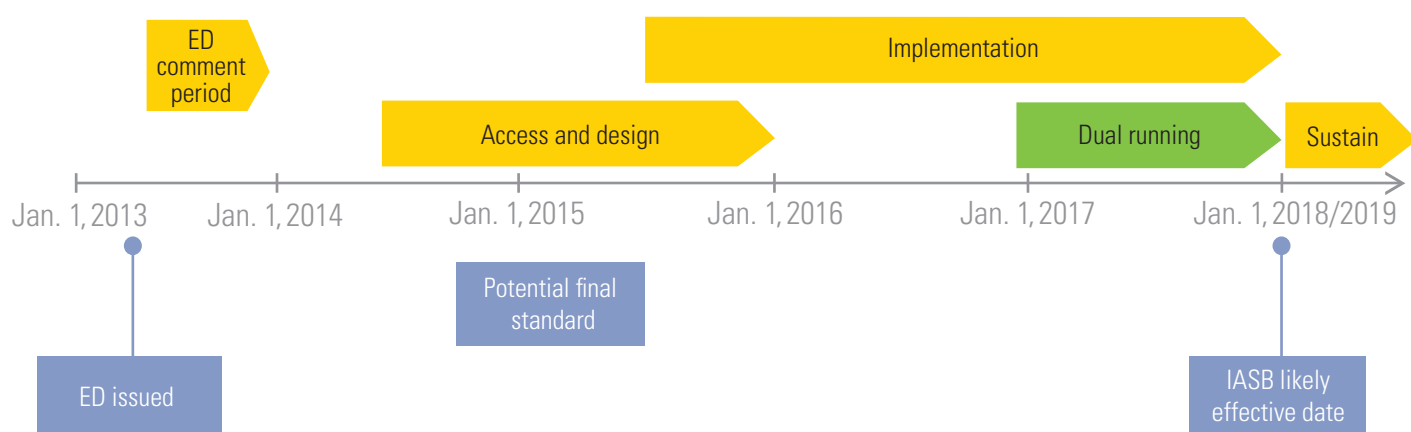
- Many insurers will be addressing the operational implications of the standards alongside established strategic programs to transform their finance and actuarial operating models. Life insurers have experienced a steady stream of increases in internal and external reporting, new products and new structures, often with interim solutions. We believe that many may have reached the stage where incremental change provides diminishing returns and opportunities for broader operational enhancement around data, systems, models, processes and people are increasingly being evaluated. The new accounting standard introduces another level of complexity, which will soon need to be incorporated within these programs.

Other insurers, however, have not been required to embark on a transformational journey. For those it's possible that the new standards will create a new wave of activity and they will need to evaluate whether their systems and processes, even with modification, are up to the task of meeting the new accounting requirements. Depending on their size and complexity, these insurers may also choose to invest in comprehensive solutions, increasing the ability to accumulate and analyze data while complying with the rigors of the new standard.

There is precedence for potential benefits to the business coming out of regulation. For instance in Europe, Solvency II has helped by providing a regulatory mandate and many insurers have used this as an opportunity to improve models and systems. By accepting these common aims, insurers can seek out ways to gain real, sustainable business benefits while addressing regulatory change.



## Potential timeline



**Note:** FASB has yet to decide on the length of the implementation period and has asked for feedback in the comment letters.



# How KPMG can help

As a global network of member firms with experience of more than 1,500 accounting change projects addressing IFRS and US GAAP, we can help you identify the issues early, and can share leading practices to help avoid the many pitfalls of such projects. KPMG firms have extensive experience and the capabilities needed to support you and your organization through the proposals' assessment and transition process.

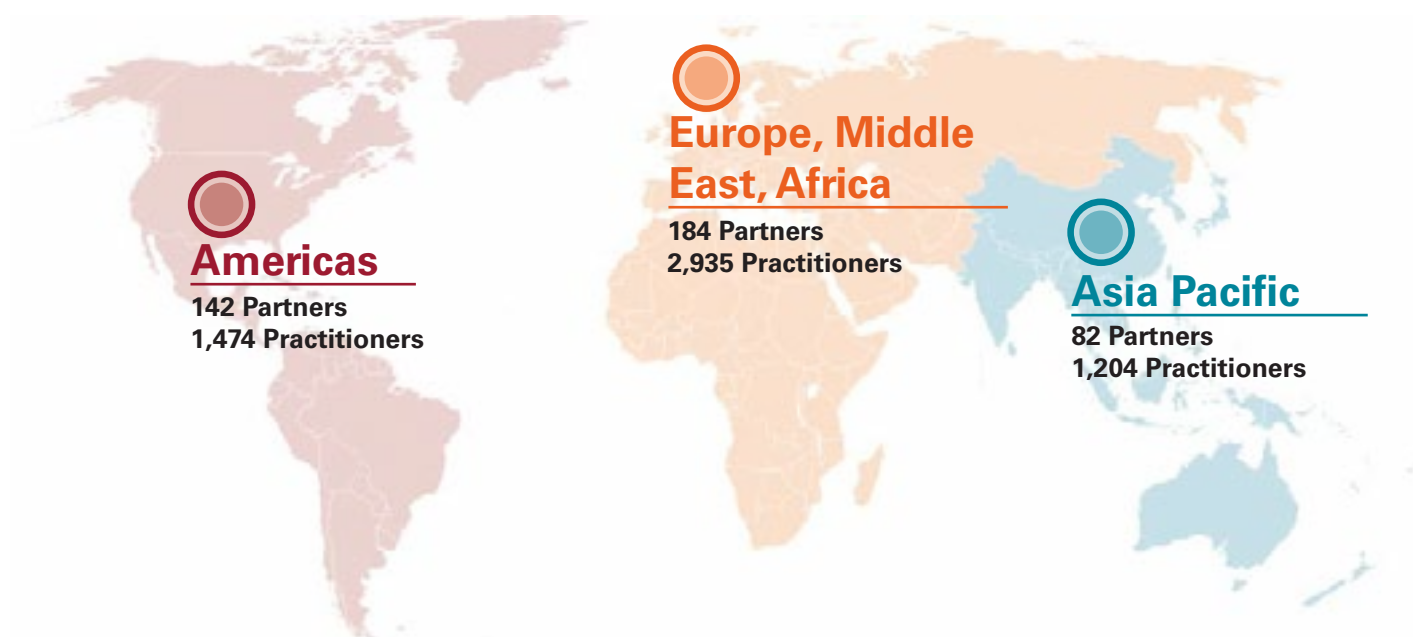
Our global network of professionals can advise you on your preparation for the forthcoming insurance contracts and financial instruments standards,

as well as identifying a coordinated approach for the proposals and other regulatory requirements, such as Solvency II. We are committed to providing a uniform approach to deliver consistent, high-quality services for clients across geographies. We look at the impacts not only as an accounting change but recognize that the whole business will be affected. Our multi-disciplinary, experienced teams in accounting, actuarial, risk and asset-liability management, regulatory, IT and tax topics can assist you in analyzing what the new accounting standards will mean for you.

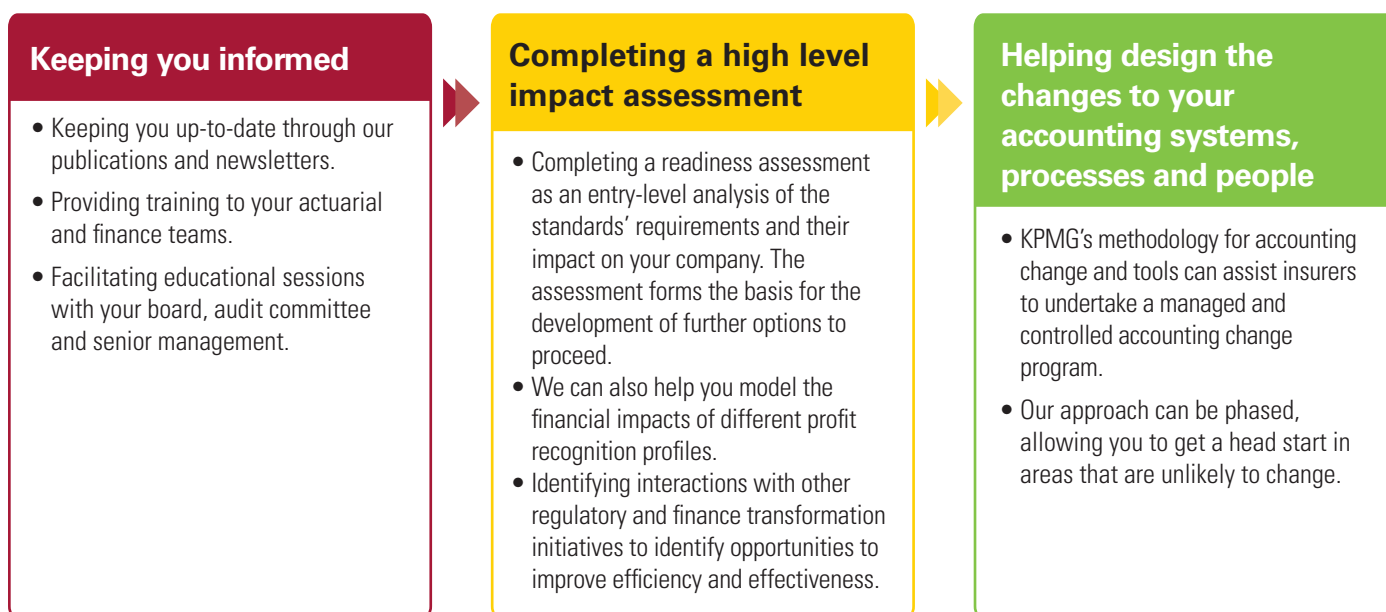
►► A final standard has never been nearer and doing nothing no longer feels like a sensible option. In my view, every insurer needs to assess where they are and what it means for them.

**Gary Reader,**  
Global Head  
of Insurance

## KPMG insurance professionals around the world



Visit [kpmg.com/insuranceaccountingchange](http://kpmg.com/insuranceaccountingchange)

**Subject to independence constraints, we can assist you by:**

►► "Insurers regularly ask me what they should be doing now that the proposals have been drafted, and I always say, 'Well, it depends'.

Your strategy will be influenced by many factors including the product mix, the quality of the existing systems and processes, the regulatory environment and your appetite to 'stay ahead of the curve'. Typically we see three types of insurers: those that just want to stay informed, those that want to be prepared and those that want to start to change now.

I recognize that given the current debate in the industry on the proposals, relatively few insurers will be in the last category, which will likely be typified by insurers that are already embarking on a large systems replacement program.

However, I see these groupings as phases through which many insurers will likely transition as the proposals are finalized.

Ultimately though, each insurer will see this differently until a final standard is published. The important thing is to consider where you are today and then to respond accordingly. Managing stakeholders' expectations is a huge part of this."

**Louis Mannello**, Global Insurance Accounting Change Leader

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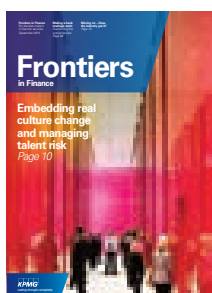
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KPMG International Standards Group (part of KPMG IFRG Limited)

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## KPMG's insurance practice

- A global network of professionals, working in member firms throughout the Americas, Europe, the Middle East, Africa and Asia Pacific, offering skills, insights and knowledge based on substantial experience.
- Offers industry-tailored Audit, Tax and Advisory services that can lead to comprehensive value-added assistance for the most pressing business and reporting requirements.
- Dedicated to supporting insurers in understanding industry trends and business, regulatory and financial reporting issues at global and local levels.

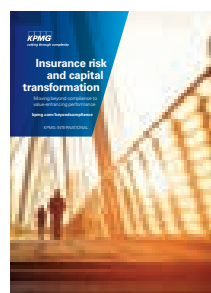
## Additional KPMG publications



### Frontiers in Finance

September 2013

Frontiers in Finance is KPMG International's Financial Services magazine covering the key issues and opportunities in Banking, Capital Markets, Insurance and Investment Management.



### Insurance risk and capital transformation

April 2013

This publication focuses on how enterprise risk management can optimize value and deliver growth.



### New on Horizons: Insurance contracts

July 2013

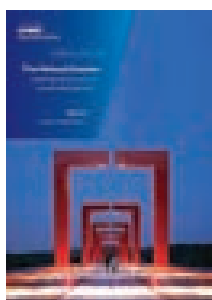
This report looks at the IASB's targeted re-exposure draft on insurance contracts, issued in June 2013, making a major step towards implementing a common insurance reporting framework across much of the world.



### Evolving Insurance Regulation: A new dawn

March 2013

This report provides a thorough review of the current regulatory landscape globally, while providing greater insight into key trends and the impacts on the insurance industry.



### The Valued Insurer: Leading the pursuit of sustainable growth

June 2013

This publication offers unique insight and opinion on emerging customer trends and channel developments in the insurance sector. We explore the four critical attributes we believe underpin an insurer's ability for success now and into the future.



### Expectations of Risk Management Outpacing Capabilities: A time for action

January 2013

This report outlines the findings of a cross-industry study of risk conducted by KPMG International and the Economist Intelligence Unit to uncover executives' perceptions of the risks facing their companies and their sense of how well their companies and industries are tackling them.

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