



SOCIETY OF ACTUARIES

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Session 94, Impact of IFRS Insurance Accounting

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IMPACT OF IFRS INSURANCE ACCOUNTING

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June 18th, 2008



IFRS – Canadian Implications

Today's Topics

- IFRS vs. existing Canadian GAAP – key similarities and differences
- The go forward implications of IFRS on companies that report/manage using CGAAP framework



The Canadian Experience

- Canadian valuation model for life insurance policy liabilities is a “principles based” and is considered by many to be most similar to emerging IFRS phase 2 model
- Framework has worked well in practice in Canada
- While there are many similarities, there are also key differences, most important of which is recognition of asset/liability interdependence in Canadian valuation model, versus independent valuation of assets/liabilities under IFRS proposals
- Canadian experience indicates significant professional guidance/infrastructure needed to support a principles based regime

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Canadian GAAP vs. IASB Proposals

Key Similarities

- Principles based framework
- Three Building Block Approach
 - ✓ best estimate cashflows
 - ✓ margin for risk
 - ✓ discounting for time value of money
- Continuously unlocking assumptions
- Gains/Loss at issue permitted [IFRS direction unclear]

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Canadian GAAP vs. IASB Proposals

Key Differences

- Treatment of asset/liability interdependence (mismatch risk)
- Discount rate used in valuation
- Exit value versus settlement value
- Exclusion of “commercial” cashflows in IASB model
- Inclusion of own credit standing in IASB model
- Margin framework
- Application to insurance contracts versus all policy related liabilities

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Comparison of CGAAP vs. IASB Proposals

Framework Component	CGAAP	Discussion Paper (IFRS)
Principles based (i.e. not rules based)	✓	✓
Discounted best estimate cashflows with margin – unlocked and is kept current with changes recorded in current period income	✓ <small>(akin to settlement value)</small>	✓ <small>(Current Exit Value)</small>
Margins	✓ <small>(for adverse deviation) (percentile approach)</small>	✓ <small>(for risk and service) (cost of capital approach)</small>
Liabilities include provision for asset/liability mismatch risk	✓	✗
Discount rates based on economics of underlying contract	✓ <small>(based on asset return)</small>	✗ <small>(risk free)</small>
Own credit standing adjustment to liabilities	✗	✓
Use of full “commercial” cash flows in valuation	✓	✗ <small>(limits on discretionary premiums)</small>
Valuation reflects par dividends and contract adjustment features	✓	✓ <small>(but potentially significant restrictions)</small>

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Is IFRS A Step Forward or Backwards?

Limitations on recognition of “discretionary” future premiums under IFRS

Limitations on recognition of “pass through” or adjustability features under IFRS

Use of risk neutral discount rates with no direct consideration of asset/liability match

▪ Clear step backwards as valuation diverges from commercial reality (both settlement and exit value perspective)

▪ Clear step backwards as valuation diverges from commercial reality (both settlement and exit value perspective)

▪ Considered more “market consistent” by advocates and clearly less subjective but:

✓ brings liquidation perspective – market liquidity volatility into financial statements for non-liquid liabilities

✓ no observable risk neutral parameters in many instances

✓ ALM and assets supporting liabilities are key driver of liability profitability and hence key drive of price in true exit/ settlement calculation

▪ Overall Canadian actuaries would consider current proposed framework a step backwards

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Is IFRS A Step Forward or Backwards?

Margin framework different under IFRS (cost of capital)

Own credit standing reflected in IFRS valuation

▪ Generates more theoretical discussion than true practical concern, both with respect to profit emergence and gain/loss at issue

▪ A step backwards

CURRENT PHASE II PROPOSALS ARE CONSIDERED A STEP BACKWARDS IN A NUMBER OF AREAS

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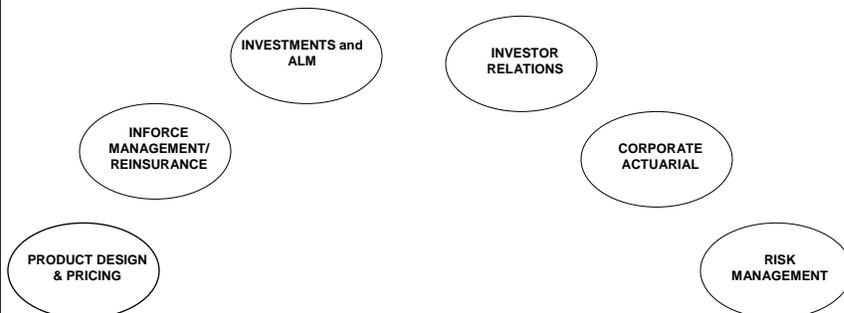
The Canadian Experience – Professional Guidance

- CICA standards explicitly recognize role of CIA in setting GAAP liability valuation standards
- Variation in practice is narrowed through supplemental guidance issued by Canadian Institute of Actuaries and by a robust control framework including:
 - Detailed professional standards and guidance for reserving
 - Mandated role and certification by Appointed Actuary
 - Mandated independent peer review
 - Detailed external audit guidelines for auditing actuarial reserves
 - Extensive disclosure requirements (eg. source of earnings)

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Functional Areas Impacted by IFRS



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Key Impacts

PRODUCT DESIGN & PRICING

Impact on product design will be material

- Limitations on cashflows recognized (term, discretionary premiums) may put pressure on high upfront acquisition cost products
 - ✓ lack of capitalization of future revenue offsets may create upfront earnings losses
 - ✓ creates pressure to modify compensation structures
- Limitations on recognition of adjustability, pass through features may reduce attractiveness of PAR/UL and other current pass through products
 - ✓ unacceptable earnings patterns (eg. unusually upfronted profits offset by unusual backend losses for PAR if future dividends not recognized)
- Limitations on recognition of discretionary premiums may create pressure to limit such features
 - ✓ early period earnings/losses offset only as discretionary premiums realized
- Use of risk free discount rates may reduce attractiveness of long duration guarantee products that rely on investment spread – key issue in North America
 - ✓ level COI or low cost UL
 - ✓ payout annuities
 - ✓ only recognize spread as earned

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Key Impacts

INFORCE MANAGEMENT/ REINSURANCE

The new accounting model will create inforce management opportunities

- There is bound to be friction between GAAP accounting and tax profit recognition creating income engineering opportunities
 - ✓ knock on impacts onto tax accounting (?)
- If cost of capital widely accepted for margins, could significantly change earnings recognition patterns for inforce business versus current release from risk approach
 - ✓ cost of capital is more level emergence than release from risk which back ends margin release for many products
- Reinsurance vehicles provide opportunities to re-engineer earnings patterns under new rules
- Accounting for embedded derivatives may highlight volatility/embedded risk of these features
 - ✓ except for segregated fund guarantees, most embedded derivatives (eg. minimum guarantees) currently fall below the radar screen

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Key Impacts

INVESTMENTS AND ALM

- Use of risk free discount curve for liabilities may increase pressure to move to vanilla risk free assets
- Potential pressure to expand use of derivatives to improve matching
- Significant difference where non risk free fixed interest assets used due to inability to recognize expected net long term expected spread; and mark to market volatility from capitalization of current market spreads change
- Significant difference where non fixed interest assets used due to inability to recognize expected net long term spread, but no change in volatility
- Early modeling suggests inability to recognize spreads in IFRS model will outweigh C3/C1 PfADs under existing model and increase liabilities

New Accounting model will provide no valuation benefits and potentially significant income volatility costs to using anything other than vanilla matched risk free assets

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Key Impacts

INVESTOR RELATIONS

- Significant investment in investor relations will be needed
 - ✓ significant changes in initial surplus levels
 - ✓ significant changes in expected profit emergence
 - ✓ potentially significant increases in income volatility
- Given analysts/markets dislike volatility, expected increased earnings volatility will be a disclosure/explanation challenge
- To extent the accounting diverges from business economics (eg. discounting approach, cashflow recognition) there will be increased pressure to use non GAAP metrics

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Key Impacts

CORPORATE ACTUARIAL

- Lack of expansive professional guidance and formal role for professional actuarial bodies will increase role of audit firms as defacto interpreter of standards
- Unclear how gap created by lack of formal certifying actuary (ie. Appointed Actuary) will be filled in a principle based GAAP regime
- As a minimum, increased certification role for Appointed Actuary is expected for solvency given OSFI solvency requirements start with GAAP balance sheet
- Actuaries likely to focus more on controls, experience studies, liability cashflows/risks and less on assets!

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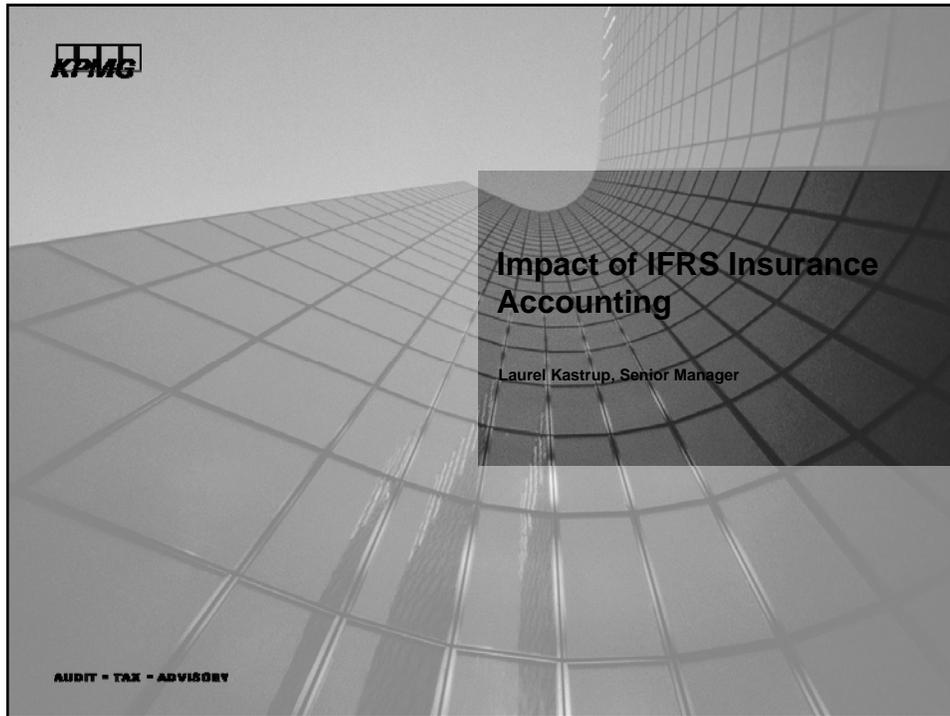


Key Impacts

RISK MANAGEMENT

- Stochastic/other sophisticated multi path modeling applications used in risk applications may make their way into valuation mainstream
- Increased focus on embedded guarantees
- To extent GAAP model diverges from economic/commercial reality, increased reliance on internal economic based models to manage internally
- ALM will move entirely into realm of internal risk management as delinked from GAAP valuation

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IFRS Phase II vs GAAP

- **IFRS PHASE II is a significant project and NOT just a financial / actuarial exercise**
- **There are significant differences between IFRS and US GAAP**
 - Loss Liability: Probability weighted estimates covering all scenarios not of necessity the GAAP defined “management's best estimate”.
 - Recognizing of time value of money.
 - Explicit incorporation of risk margin in reserve estimates.
 - Under IFRS, consistent with US GAAP, Gross Loss and LAE reserves are recorded as liability with reinsurance recoverables offset as asset.
 - UPR eliminated – Liabilities will be incorporated in expected future cash flows under pre-claim liability.
 - DAC eliminated – Acquisition costs will be expensed when incurred.
- **There likely will be fundamental shifts in roles and responsibilities, processes and management decision-making associated with IFRS implementation**



Liabilities Under Phase II and FAS 157/159

Title	IFRS Phase II	FAS 157/159	Issues
Assumptions	<ul style="list-style-type: none"> • Discounted, explicit, unbiased market-consistent, probability-weighted current estimates of contractual cash flows • Explicit unbiased estimate of the margin market participants require for bearing risk and providing other services • Allowance for own credit risk 	<ul style="list-style-type: none"> • Price that would be received to transfer a liability • Fair value hierarchy that gives the highest priority to quoted prices in active markets and lower priority to unobservable data • Transfer in the principal or most advantageous market • Reflect non-performance risk 	<ul style="list-style-type: none"> • Is there a principal market for insurance liabilities? • If the most advantageous market is used, who are the market participants?
Discount rate	<ul style="list-style-type: none"> • Risk Free Rate (unless cash flows depend contractually on the cash flows from underlying assets) • Observable current market rates for cash flows whose characteristics match those of the insurance liability (timing, currency & liquidity) 	<ul style="list-style-type: none"> • Risk Free Rate 	<ul style="list-style-type: none"> • What cash flows should be used?



Liabilities Under Phase II and FAS 157 (continued)

Title	IFRS Phase II	FAS 157/159	Issues
Profit recognition	<ul style="list-style-type: none"> • Gains may be recognized at inception (unless risk margin is calibrated to premium less relevant acquisition costs) • Changes in carrying amount of insurance liabilities are recognized immediately in profit or loss 	<ul style="list-style-type: none"> • Day one gains or losses permitted 	<ul style="list-style-type: none"> • Certain factors need to be considered in determining whether the transaction price represents the fair value
Allowance for future cash flows / risks	<ul style="list-style-type: none"> • Include only cash flows arising from contractual rights and obligations 	<ul style="list-style-type: none"> • Risk margin should be consistent with the margin that the insurer would expect to pay to transfer its obligations • Should reflect all risks associated with the liability 	<ul style="list-style-type: none"> • Risk margins should be explicit • Should be as consistent as possible with observable market prices
Cost of capital	<ul style="list-style-type: none"> • Cost of capital could be used in estimating risk margins if it complies with the criteria for defining a risk margin 	<ul style="list-style-type: none"> • FAS 157 does not specify • Valuation techniques shall be consistent with the market, income and/or cost approach 	<ul style="list-style-type: none"> • Cost of Capital may not represent the margin that market participants would require



Liabilities Under Phase II and FAS 157 (continued)

Title	IFRS Phase II	FAS 157/159	Issues
Confidence intervals	<ul style="list-style-type: none"> May be required as a disclosure requirement 	<ul style="list-style-type: none"> FAS 157 does not specify Valuation techniques consistent with the market approach, income approach and/or the cost approach shall be used 	<ul style="list-style-type: none"> A principles-based standard is unlikely to specify, therefore the industry may need to issue guidance or best practice will emerge
Unit of account	<ul style="list-style-type: none"> Portfolio of insurance contracts subject to broadly similar risks and managed together as a single portfolio 	<ul style="list-style-type: none"> Generally determined pursuant to the guidance in other applicable GAAP specific to the asset or liability being considered For Level 1 measurements, it is the individual financial instrument 	<ul style="list-style-type: none"> Too broad to be consistent with FAS 157 Too narrow to be consistent with some regulatory requirements (e.g. Solvency II) or many internal capital models
Options and Guarantees	<ul style="list-style-type: none"> Implicitly allowed for in prospective cash flow scenarios 	<ul style="list-style-type: none"> Implicitly allowed for in prospective valuation 	<ul style="list-style-type: none"> Important to consider the full range of scenarios



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The fair value option (FAS 159)

- Companies may elect to measure certain financial assets and liabilities with changes in fair value recognized in earnings each reporting period
- Unlike FAS 157, the fair value option can be elected at a company's discretion
- Irrevocable election to measure fair value through earnings
- Election made upon adoption of the Standard or the date the financial asset or liability is recognized / acquired
- Requires a "one-time" cumulative-effect adjustment to retained earnings on adoption
- Made on a contract by contract basis
- Reflects the current financial position of a company rather than the historical transaction price
- Provides further convergence with international standards
- If elected, must be adopted concurrently with FAS 157
- Applicable to fiscal years beginning after November 15, 2007
- Specific scope exceptions



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Key Insights

- Moves us from “implicit” reserving margins to explicit (market consistent) risk margins above a current expected present value liability.
- The change from implicit to explicit reserving margins will increase the volatility of reported profits due to changes in discount rates, expected future cash flows and risk margins from one period to the next.
- If new business volumes year on year are fairly consistent, changes in assumptions will have the greatest impact on the volatility of reported profits.
- The Board did not anticipate that significant profits would be recognised on inception if implementation B were adopted as they do not believe that there is a significant difference between the margins in the retail market and the market between the insurer and a hypothetical transferee (another insurer).



Issues with IFRS

- Credit Standing
 - Will be a factor in discount rate for liabilities
 - If an insurers credit standing decreases, the liabilities would also decrease; this is counter-intuitive and will be difficult to explain
- Earnings Volatility
 - Due to mismatch between assets and liabilities
 - Even if assets and liabilities well-matched due to differences in how some assets are valued (i.e. not at fair value)
 - Non-parallel shifts in credit spreads
 - Changes in liability experience and assumptions could lead to large gains and losses
- Gain at Issue
 - Gains at issue would be permitted
 - Front-loaded profits on some products, could lead to “innovative” product development



Issues with IFRS (continued)

- Losses at Issue
 - Could occur even if premium is adequate to cover benefits and expense but not adequate to cover a risk margin consistent with the market
 - Efficient expense structure leads to lower premiums; however, insurer not permitted to recognize entity specific expenses—leads to higher profits later
 - For long-duration products with significant investment component, since earned rate is not used for discounting
 - If future premiums are not recognized (i.e. UL or variable annuity)
 - If lapses are determined to be beneficial policyholder behaviour are not recognized for lapse-supported products



Key IFRS Considerations

- Expected Value of Future Cash Flows
 - Does today's nominal reserve represent the mean of the distribution of future cash flows?
 - What documentation will be required to support an assertion that the nominal estimate reflects the probability weighted estimate of all possible cash flow outcomes?
- Discount
 - Duration of payment stream implies greater benefit from consideration of time value of money
- Risk Margin
 - By far, the most difficult of the three building blocks
 - Longer-tailed lines will generally have a higher relative risk margin



Observations on Risk Margin

What Matters?

- Observed Volatility
- Consider both parameter and process risk
- Size of portfolio influences
- Duration to settlement



What Happens Under IFRS When....

- Risk-free interest rate changes at a later valuation?
- Nominal estimate changes?
- There is significant catastrophe exposure? Seasonality?
- New types of loss emerge?

- Consider the impact on:
 - Nominal estimate
 - Discounting
 - Risk Margin



Management Issues

- **Role of the actuary under IFRS**
 - Explicit recognition of discounting and risk margins likely expands the role of the actuary
 - Actuarial processes will need to be more transparent, incorporating differing views within the Company
 - Documentation – disclosures will be more extensive and changes from period to period will need to be transparent
- **Management decision-making processes and metrics will fundamentally change**
 - How will your planning and budgeting processes change under IFRS?
 - Key metrics will no longer exist. What metrics will replace them?
 - Financial reporting processes will change dramatically, with added pressure to produce quality estimates on a timely basis
 - What controls will exist to ensure consistency (or at least transparency) of approach among insurers?



Significant Strategic Issues

- **Increased volatility of financial results**
- **Significantly increased disclosure requirements**
- **Systems Requirements**
- **Governance Considerations**
- **Regulatory Reporting**



Timetable

- | | | |
|-----------------------------|---|------------------|
| • Discussion Paper | – | 3 May 2007 |
| • Closing date for comments | – | 16 November 2007 |
| • Exposure Draft | – | Not before 2009 |
| • Final Standard | – | Not before 2011 |
| • Implementation | – | Not before 2012 |

IASB has not committed itself to a timetable, so dates for Exposure Draft, Final Standard and Implementation are tentative.

There may be further delays if Phase II becomes a joint project with the FASB.



Interaction with FASB

- The FASB and the IASB agreed to approach the IASB's insurance contracts project using a modified joint approach
- FASB will consider the IASB's Discussion Paper
- FASB has obtained input on the IASB's preliminary views by issuing an Invitation to Comment
- Feedback on the Invitation to Comment will be used by the Board in deciding whether to add to its agenda a joint project with the IASB to develop a comprehensive Standard
- FASB Decision expected Q3 2008



Interaction with SEC

- SEC eliminated US GAAP reconciliation for foreign private issuers using IFRS for years ending after November 15, 2007
- SEC is currently considering a rule allowing domestic companies to choose to file under IASB accounting standards if they wish
 - Sources familiar the SEC, confirmed that chair-man Christopher Cox was preparing to announce a timetable which would give US companies a roadmap to the final switch to IFRS
 - Expectation in the US that the SEC will make a rules proposal some time in June which will consist of a roadmap of a series of actions and steps that need to be taken, some of which are structural, in terms of the structure and funding of the International Accounting Standards Board.



Next Steps

- FASB will decide whether to join the project
- IASB (and FASB?) to consider the extent to which it may wish to change the preliminary views
 - IASB will need to consider whether alternative proposals are consistent with the likely outcomes of other projects
 - Whether there is a technically sound case for treating certain aspects of insurance differently from other industries
 - Will be informed by round table discussions and Insurance Working Group
 - Likely need to field test certain of the (modified) proposals, subject to resource constraints
- Exposure Draft – challenging to issue in 2009
- Possible need for further field testing etc, depending upon responses to ED
- Final Standard – challenging to issue by 2011
- May be influenced by the updating and revision to the Memorandum of Understanding between the IASB and the FASB



Impact of IFRS Insurance Accounting

Carol Salomone, Vice President
June 18th, 2008
SOA Life Spring Meeting, Quebec City



Request from German parent for data to begin understanding IFRS accounting

Objectives

- Investigate impact on financial results
- Apply "Principles for an IFRS Phase II Insurance Model" by the CFO Forum
- Report effect on balance sheet and P&L
- Review impact on profitability pattern for new business

Methodology to apply CFO Principles for IFRS Phase II

- Market consistent evaluation of liabilities
- Includes option and guarantees (O&G) values
- Use methodology, results and tools of market consistent embedded value (EV)

Approach

- Start with information from EV process 2006
- Further breakdown of results to product types (IFRS Classification) might be needed

IFRS Phase II Developments

Two separate proposals, one from CFO Forum, one from CRO Forum
Both proposals recommend a fair value liability with risk margins

Several Key Differences Between Proposals

- CRO Forum proposal
 - All Acquisition Expenses expensed through income at issue
 - No profit margin – All Gain/Losses recognized at issue except for:
 - the later release of risk margins and cost of capital
 - as future experience diverges from the initial assumptions
- CFO Forum Proposal
 - All Acquisition Expenses, both fixed and variable, capitalized at issue, as Customer Intangible Asset (CIA). Note that an equal CIA liability is also established and amortized in parallel, so no net effect on profit.
 - Profit at Issue (prior to capitalization of CIA) is capitalized as profit margin
 - Both CIA and Profit Margin emerge into profit with the release from risk (ie, in line with the risk margin runoff).

Quick Look at IFRS Phase II Balance Sheet

Simple Product Features

- \$1,000 Single Premium 5 Year SPDA
- Risk Free Earned Rate—3%
- Investment Spread—1%
- Risk Free “Credited Rate”—2%
- Acquisition Expense—\$25
- No Maintenance Expense
- No Withdrawals before end of 5th year

- Best Estimate Liability at Issue = $\$1,000 \cdot (1.02)^5 / 1.03^5 = \952
- Risk Margin = \$10 (calculated outside this presentation)
- Assume no cost of options and guarantees

Quick Look – Continued

CRO Forum Approach

Assets

Tangible Assets \$975

Total Assets \$975

Liabilities

BEL \$952

Risk Margin \$ 10

Total Liabilities \$962

Gain @ Issue \$ 13

CFO Forum Approach

Assets

Tangible Assets \$975

CIA \$ 25

Total Assets \$1000

Liabilities

BEL \$952

Risk Margin \$ 10

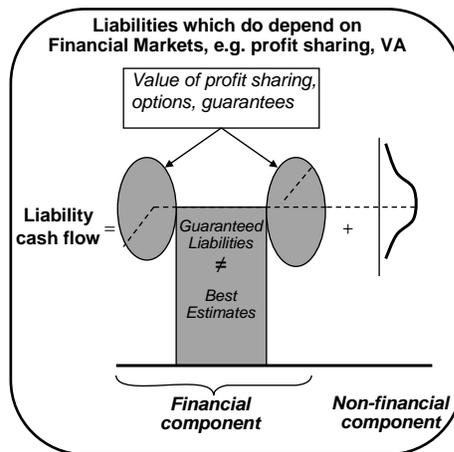
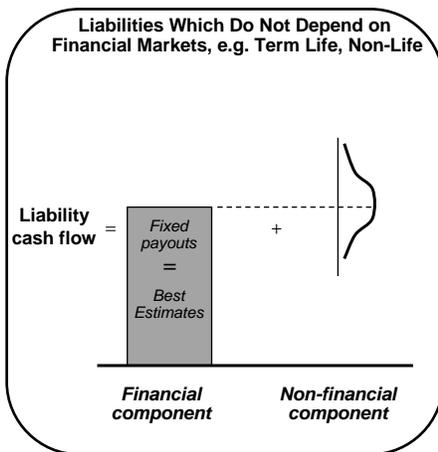
CIA \$ 25

Profit Margin \$ 13

Total Liabilities \$1000

Gain @ Issue \$ 0

Theory of Best Estimate Liability + Risk Margins for Market Value Margins*



More Theory

Financial component or Best Estimate Liability (BEL)

Valuation is determined using capital markets valuation models with reference to the prices and valuation curves (e.g. zero coupon swap curves, volatility surfaces, etc.) found in the financial markets. Implications:

- Management's expectations regarding future investments returns and equity market developments do not influence the valuation;
- Similarly expected spreads on assets are not recognised up-front;
- By reference to financial market pricing, risk margins are included automatically

Non Financial component or Risk Margins

The uncertainty in non-financial risks is valued applying a *mark-to-model* approach.

- The risk margins should refer to the market value margin, the reward an independent buyer would require for taking the risk
- This can be expressed as charging an additional margin in order to cover the cost of Economic Capital related to retaining those non-financial risks

Preliminary Methodology

Our German parent requested that several of the larger operating entities create preliminary IFRS Phase II financials based on the CFO Forum proposal, using data already reported via MCEV work.

To facilitate analysis, several approximations were implemented:

- Year-end 2005 and 2006 Market Consistent Embedded Value (MCEV) results should be used where ever possible
- Stochastic PVFP is equal to deterministic PVFP adjusted for value of options and guarantees
- Profit Margin is set equal to the above stochastic PVFP
- Risk Margin is set equal to cost of non-financial risk
- Best Estimate Liability is set equal to MV of assets less Stochastic PVFP
- Customer Intangible Asset (CIA) is proxied by adjusting current DAC for fixed acquisition expenses not currently capitalized

Adjustments to the above approximations were allowed where results were not reasonable. For Allianz Life, adjustments to the profit margin were required.

Profit Margin Calculation Implications

- CFO Forum recommends profit margin set at issue equal to PV of future profits
- CIA is set equal to acquisition expenses at issue. For profitable products, profit margin will be greater than CIA
- Both profit margin and CIA are amortized as a % of risk margin, so ignoring unlocking events, profit margin will always be greater than CIA
- Stochastic PVFP from MCEV recalculates future profits each year, based on current economic conditions and inforce characteristics, and will be reduced each period for actual economic profits recognized in the period.
- For products where fund accumulation is the major source of risk, current stochastic PVFP is not a good proxy for inferring the initial profit margin. In contrast, using current stochastic PVFP for life products with level premiums is a good proxy.

Profit Margin – Continued

- Based on 2005 MCEV results and the initial recommended method to approximate the inferred current profit margin:
 - CIA - \$4.5B
 - Profit Margin - \$3.0B
- Profit margin was recalculated taking average profit margin at sale by product, pre-acquisition expenses, applied to premium over the last five years.
 - Amortization of 5% per year was assumed.
 - Assumed pre-2002 business contributed 10% of total remaining profit margin
- Adjusted 2005 Results:
 - CIA - \$4.5B
 - Profit Margin - \$5.6B

Other Challenges with IFRS Accounting

- Day 2 Issues

- Even if all experience emerges as expected, projections for future years will change each year as one year of actual experience is substituted for one year of projected experience based on guarantees
- A positive outcome of market consistent accounting is that investment strategies must recognize product guarantees in order to be successful

- A different way of viewing results than we what we are used to
 - IFRS uses Best Estimate Liability, which is the present value of future benefits and expenses rather than the FAS 97 accumulation of premium at interest; until one becomes accustomed to this, comparison of results is not intuitive

Sample IFRS Income Statement

	<u>In Force</u>	<u>New Business</u>
Risk Free Return on Beginning Equity	175,235	0
Release of Profit Margin	571,688	27,032
Release of Risk Margin	16,403	285
Release of O&G	192,860	0
Amortization of CIA	(455,490)	(17,093)
Change in Scenarios	315,834	0
Excess Investment Return	83,572	250
Operating Variances	<u>(230,961)</u>	<u>2,785</u>
Total Income	669,141	13,009

Wrap up

- Many ways to begin approximating results
- The sooner companies start evaluating the impact, the easier the transition will be
- Reconciling USGAAP to IFRS, while perhaps not strictly required, can be useful in explaining results