Seeing Beyond Risk Canadian Institute of Actuaries Institut canadien des actuaires Voir au-delà du risque

Educational Note

Implications of CICA Accounting Standards 3855 and 1530

Committee on Property and Casualty Insurance Financial Reporting

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Educational Notes do not constitute standards of practice. They are intended to assist actuaries in applying standards of practice in respect of specific matters. Responsibility for the manner of application of standards in specific circumstances remains that of the Member in the Property and Casualty Practice Area.

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Memorandum

To: All Property and Casualty Practitioners

From: Shawn Doherty, Chairperson
Committee on Property and Casualty Insurance Financial Reporting

Date: January 3, 2007

Subject: **Educational Note – Implications of CICA Accounting Standards 3855 and 1530**

The Accounting Standards Board (AcSB) introduced new[1] standards to address *when*[2] an entity would recognize a *financial instrument* on its balance sheet and *how* the financial instrument would be measured once recognized. The new standards include the following Sections[3] in the Canadian Institute of Chartered Accountants (CICA) Standards and Guidance Collection:

- CICA 3855, Financial Instruments – Recognition and Measurement; and
- CICA 1530, Comprehensive Income.

The new standards are effective for annual and interim accounting periods in fiscal years beginning on or after October 1, 2006.

Insurance contracts are excluded from the scope of the new standards and are therefore not *directly* impacted. However, the use of a portfolio-based discount rate in the determination of the actuarial present value of the policy liabilities results in an *indirect* impact. As such, practitioners are encouraged to review the new standards.

The implementation of the new standards creates some challenges and complications for Property & Casualty (P&C) insurance company financial reporting, particularly for actuaries responsible for measuring policy liabilities for Canadian Generally Accepted Accounting Principles (GAAP) financial statements. This educational note briefly describes the new standards for financial instruments, and identifies the issues and challenges that these standards create for valuing policy liabilities and for Dynamic Capital Adequacy Testing (DCAT) analyses.

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[1] The standards discussed herein will be referred to as "new" based on the timing of publication of this note and the effective date of the standards.

[2] Throughout this document italics are used to identify the first instance of a new term, to draw the reader's attention to an important point, or to add emphasis.

[3] CICA 3865, Hedges was also introduced as a new Section. However, it is assumed that Section 3865 is not pertinent to the majority of P&C insurers and is therefore not discussed in this document.

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This educational note does not address transitional issues related to the implementation of the new standards. The actuary, however, would consider such issues. In particular, it is expected that changes introduced to the Minimum Capital Test and the Branch Asset Adequacy Test[4] would require actuaries to make modifications in existing DCAT models. Preliminary tests show that the impact of fair value accounting on the levels of the current Capital Tests would be limited for the industry as a whole. In its current form, it is expected that the Capital Tests would mainly be affected by the following three items:

- adjustment for excess of market value over current book value (only 50% of that excess is recognized in the Capital Tests pre-CICA 3855);
- capital required for assets (the book value of some or all assets may change); and
- capital required for unearned premiums and unpaid claims (because the actuarial present value may change).

Given the inherent variability of the market yields over time, it is likely that the introduction of the new standards will increase the volatility of the Capital Tests. In the DCAT Report, the actuary would be expected to discuss the impact of the changes in accounting standards on the insurer's Capital Tests results and the future financial condition of the company.

Paragraph 2140.01 of the Canadian Institute of Actuaries (CIA) Standards of Practice (SOP) makes clear that the actuary's opinion is in relation to the valuation of the policy liabilities and the presentation of such on the balance sheet. SOP paragraph 2140.06 emphasises that the total change in the policy liabilities during the accounting period is accounted for in the statement of income. The new standards do not impact these SOPs, and, therefore, the changes to the new standards will not, in and of themselves, create the potential for a qualified actuarial opinion. Nonetheless, the actuary would consider the impact of the initial change due to the new standards and, if material, disclose the impact (see SOP paragraph 2140.11 on consistency among accounting periods).

Accounting standards are in a state of evolution, both internationally and within Canada. For the purpose of this educational note, we refer to CICA 3855 and CICA 1530 as the "new" standards. We recognize that CICA 3855 and 1530 will be considered "new" for a limited time only and that this educational note will only be relevant during that limited time-frame. Nevertheless, for ease of reference in this document, we use the terminology "new standards" to refer to CICA 3855 and 1530.

In accordance with the CIA's Policy on Due Process for Approval of Practice-Related Material Other than Standards of Practice, this educational note has been approved by the Property and Casualty Financial Reporting Committee (PCFRC), and received final approval for distribution by the Practice Council on December 28, 2006.

This educational note is subject to SOP subsection1220, which states: "*the actuary should be familiar with relevant educational notes and other designated educational material*," and be aware that a "*practice which the notes describe for a situation is not necessarily the only accepted practice for that situation and is not necessarily accepted*

[4] For ease of reference, these two tests will be referred to as "Capital Tests" throughout the remainder of this document.

actuarial practice for a different situation," and that "*educational notes are intended to illustrate the application (but not necessarily the only application) of the standards, so there should be no conflict between them*."

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1. INTRODUCTION

Canadian accounting standards 3855 and 1530 are effective for annual and interim accounting periods in fiscal years beginning on or after October 1, 2006. These new standards, affecting all companies, including P&C insurance entities, are described at a high level in Section 2 of this educational note and in more detail in Section 4.

The new standards focus on the measurement of financial instruments and how the associated changes are recognized in financial statements. In addition to the new standards, the Office of the Superintendent of Financial Institutions (OSFI) has issued Guideline D-10 *Accounting for Financial Instruments Designated as Fair Value Option* (Guideline D-10) that provides further guidance on criteria for use of the fair value option in CICA 3855.19 (f) (ii) dealing with financial assets or financial liabilities designated upon initial recognition as held for trading for federally regulated financial institutions. Guideline D-10 is also discussed in detail in Section 4, and its applicability to the actuary is included in the discussion throughout Section 3. Due to the potential impact on actuarial processes, particularly the determination of policy liabilities and DCAT, management may seek the actuary's advice on categorizing assets under the new standards. Considerations for the actuary to aid in this process are outlined in Section 3.1.

Under the new standards, it is possible that some or all invested assets that support policy liability cash flows will be measured in financial statements on a fair value (i.e., marked-to-market) basis. Similar rules were adopted in the US and met with little fanfare by the US actuarial community because policy liabilities in the US are not discounted. As such, invested assets in the US are generally categorized as *available-for-sale* so that changes in fair value of these assets flow through *other comprehensive income*, and net income is not impacted. From an income statement standpoint, the changes in the US did not have much impact.

By contrast, these changes will have implications for actuaries in Canada because of the discounting of policy liabilities. In particular, SOP paragraph 2240.01 states, "The expected investment return rate for calculation of the present value of cash flow is that to be earned on the assets which support the policy liabilities." Accordingly, a change in the measurement of the value of the assets affects the measurement of the investment return rate and, hence, has an impact on the net present value calculation of policy liabilities. As a result, net income would be impacted even if an entity selected the available-for-sale category for invested assets. A discussion of this along with other related issues is included in Section 3.2.

Further, the change in measurement and presentation of financial instruments in financial statements can have an impact on actuaries' DCAT analyses. A discussion of DCAT and the new standards is presented in Section 3.3.

The order of the sections in this educational note emphasizes the impact to the actuary so that Section 3, Implications to P&C Actuaries, precedes Section 4, Detailed Discussion of CICA 3855 and 1530. Readers unfamiliar with the new standards are encouraged to read Section 4 before Section 3, as familiarity with the content of Section 4 will make the discussion of the implications in Section 3 easier to follow.

Finally, at the time of writing, usage of the terms *book value* and *book yield* may erroneously be associated with an accounting valuation based on an amortized cost methodology simply because this has long been the method used to *book* results to financial statements. Further, "book yield" outside of the actuarial field traditionally considers the yield as measured on initial purchase price. As stated in the July 2005 CIA educational note, *Discounting*, "The book value of an asset may be the market value, the amortized value, or such other value consistent with Canadian generally accepted accounting principles." This latter definition of book value and the associated book yield is used throughout this educational note.

2. BACKGROUND

GAAP vary by jurisdiction, and the associated accounting standards are established by different bodies. In particular, international standards, referred to as the International Financial Reporting Standards (IFRS), are developed by the International Accounting Standards Board (IASB) and are now used by the European Union and a number of major countries. The accounting standards used in the US are established by the Financial Accounting Standards Board (FASB); Canadian accounting standards are established by the AcSB. The CICA promulgates the AcSB standards and guidance to its membership through the CICA Standards and Guidance Collection, better known as the *CICA Handbook*.

In October 2002, the FASB and the IASB issued a memorandum of understanding ("Norwalk Agreement"), which marked a significant step toward formalizing their commitment to the convergence of US and international accounting standards.

The AcSB has worked to minimize differences between US GAAP and Canadian GAAP over the last several years. The AcSB has now formally endorsed the IFRS and is committed to moving to the IFRS[5] over the next five years.

To this end, the AcSB introduced new standards for an entity's[6] use of financial instruments and for presentation of financial instruments when included in the balance sheet. The new standards address when an entity would recognize a financial instrument on its balance sheet and how it would measure the financial instrument once recognized. The new standards that are the focus of this educational note comprise two[7] new *CICA Handbook* Sections:

- **Section 3855**, Financial Instruments – Recognition and Measurement

  This section describes when to recognize a financial instrument on the balance sheet and at what amount and specifies how to present related gains and losses.

[5] A comparison between Canadian GAAP and IFRS at March 31, 2005 can be found on the AcSB website: www.acsbcanada.org.

[6] The new standards apply to all entities in Canada, not just financial institutions. Further information about the new standards is available on the Financial Instruments project page of the AcSB website: www.acsbcanada.org.

[7] CICA Section 1650 was also replaced by Section 3865, Hedges. This new Section provides an alternative treatment to Section 3855 when an entity chooses to designate qualifying transactions as hedges for accounting purposes. A discussion of the impact of this new Section is not included in this educational note based on the view that CICA 3865 does not impact the majority of P&C insurers.

- **Section 1530**, Comprehensive Income

  This section specifies the new requirements for temporary presentation of certain gains and losses outside of net income.

According to the AcSB's "Financial Instruments – Navigating New Waters," a financial instrument is "a contract that creates a financial asset for one party and a financial liability or equity instrument for the other party." *Financial* means "the contract will settle for cash (or an equity instrument if it is an asset) either directly or indirectly." It is important to note that while insurance contracts are financial instruments, they are currently excluded from the new CICA sections.

Nonetheless, the new standards do have an impact on the valuation of policy liabilities. Specifically, SOP paragraph 2240.01 states:

> "The expected investment return rate for calculation of the present value of cash flow is that to be earned on the assets which support the policy liabilities. It depends on
>
> the method of valuing assets and reporting investment income,
>
> the allocation of those assets and that income among lines of business,
>
> the return on the assets at the balance sheet date,
>
> the yield on assets acquired after the balance sheet date,
>
> the capital gains and losses on assets sold after the balance sheet date, and
>
> investment expenses, and losses from default (C1 risk)."

As such, it is expected that the new standards will have an impact on the determination of the discount rate used in calculating policy liabilities. The actuary is encouraged to review the new standards to understand the full extent of the changes to the accounting standards affecting P&C insurance companies.

3. IMPLICATIONS FOR P&C ACTUARIES

3.1 Actuarial Considerations for Asset Classification

The classification of assets under CICA 3855 will impact policy liability valuations and DCAT modeling. The actuary needs to understand the impact of decisions regarding classification particularly since actuarial input may be solicited by management. Sections 3.1.1 to 3.1.4 present some of the key implications of the classification decision for the actuary to consider. For each of the classification options, tables have been included that summarize the impact of increases and decreases in the market interest rates on various components of the financial statements, assuming investment in debt securities only. The tables are illustrative only as the total impact on income and equity will depend on such things as the mix of invested assets (e.g., debt vs. equity securities), level of duration matching between invested assets and policy liabilities, and the relative quantum of each. Sections 3.2 and 3.3 contain details of the implications of the new standards of the valuation of policy liabilities and DCAT, respectively.

Readers seeking further details of the new standards are directed to Section 4 of this educational note.

3.1.1 Held-to-maturity Investments

The accounting for this category is essentially the same as that used for bonds prior to the new standards as subsequent measurement is on an amortized cost basis.[8] With this asset classification, net income is not affected by changes in fair value while the asset is held (except in the case of impairment). Thus, there appears to be no change in volatility associated with net income, asset values, or equity values under this category relative to the current accounting standards (see tables that follow).

An important consideration is that there is a consequence for *tainting* the held-to-maturity asset category by selling of "more than an insignificant amount" of those assets.[9] The consequence is that *all* held-to-maturity assets must be reclassified as available-for-sale for at least two years,[10] which could result in a discontinuity in investment income.[11]

The consequence for tainting the held-to-maturity portfolio is considered a major impediment to using this category because it potentially reduces flexibility in managing the portfolio for rebalancing or strategic benefit, and it creates significant reporting challenges if asset sale/redeployment becomes attractive. As a result, it is anticipated that prior to selecting this classification, management would give careful consideration to the potential for unusual cash flow requirements (e.g., unusually large claims payments, dividend payouts, etc.) resulting in the need to liquidate held-to-maturity assets.

If all debt securities invested assets are held-to-maturity, all things equal, changes in market interest rates have no affect on an insurer's financial statements.

Market Rates INCREASE

Held-to-maturity debt securities	Assets	Liabilities	Total
Invested Assets Values	no effect		
Discount Rate for Actuarial Liabilities		no effect	
Actuarial Liabilities		no effect	
Net Income	no effect	no effect	no effect
Other Comprehensive Income	no effect	no effect	no effect
Equity	no effect	no effect	no effect

Market Rates DECREASE

held-to-maturity debt securities	Assets	Liabilities	Total
Invested Assets Values	no effect		
Discount Rate for Actuarial Liabilities		no effect	
Actuarial Liabilities		no effect	
Net Income	no effect	no effect	no effect
Other Comprehensive Income	no effect	no effect	no effect
Equity	no effect	no effect	no effect

[8] CICA 3855.19(k) defines amortized cost of a financial asset or financial liability as specifically using the "effective interest method" (defined in CICA 3855.19(l)). This may differ from an entity's practice pre-3855 where other methods to calculate amortized cost may have been used.

[9] Please refer to CICA 3855.26, 3855.28, and 3855.29 for a list of exceptions. In particular, CICA 3855.29 lists the six considerations under which a premature sale would not trigger the reclassification and is therefore recommended reading.

[10] Please refer to CICA 3855.26 and 3855.83.

[11] Please refer to CICA 3855.76(b).

3.1.2 Available-for-sale

Assets designated as available-for-sale will be carried on the balance sheet at fair value. The regular investment income for these assets (dividends and bond coupons) as well as changes in the amortized cost (i.e., to account for the amortization of premiums or discounts), and realized gains and losses are booked to net income. However, changes in the difference between the fair value (including the impact of foreign exchange translation) and the amortized cost will be recorded as other comprehensive income.[12] This has the benefit of segregating the volatility of fair value measurement of invested assets outside of net income. Nonetheless, asset and equity values would be more volatile than under the current accounting standards.

To the extent that policy liabilities are backed by assets classified under this category, the fair value measurement may, in part, be re-introduced into net income. For example, an increase in fair value of invested assets would decrease the portfolio yield, leading to a decrease in the discount rate used in calculating policy liabilities, causing an increase in the policy liabilities. This increase in the value of liabilities would flow through net income. As such, the volatility of both liabilities and net income may increase relative to that under the pre-CICA 3855 accounting standards. In addition, an income mismatch is generated since the change in the value of the asset flows through other comprehensive income, while any associated change in policy liabilities due to the change in discount rate would flow through net income. These two changes would be offset (at least partially[13]) in *comprehensive income* (the sum of net income and other comprehensive income).

The tables below contrast the impact on the financial statements, where all debt securities invested assets are classified as available-for-sale and market interest rates increase or decrease.

Market Rates INCREASE

available-for-sale debt securities	Assets	Liabilities	Total
Invested Assets Values	↓		
Discount Rate for Actuarial Liabilities		↑	
Actuarial Liabilities		↓	
Net Income	no effect	↑	↑
Other Comprehensive Income	↓	no effect	↓
Equity	↓	↑	depends

Market Rates DECREASE

available-for-sale debt securities	Assets	Liabilities	Total
Invested Assets Values	↑		
Discount Rate for Actuarial Liabilities		↓	
Actuarial Liabilities		↑	
Net Income	no effect	↓	↓
Other Comprehensive Income	↑	no effect	↑
Equity	↑	↓	depends

[12] This can be thought of as booking changes in unrealized gains/losses to other comprehensive income.

[13] The extent of the offset depends on the level of invested assets in excess of those supporting policy liabilities, and the duration matching of policy liabilities and the supporting assets.

3.1.3 Held-for-trading including Fair Value Option

Assets classified as held-for-trading or fair value option will be marked to fair value, with gains and losses recognized immediately in net income. These changes may result in greater volatility of assets and investment gains and losses of these assets than under the current accounting standards.

CICA 3855 allows any financial assets or liabilities to be designated as held-for-trading, but this optional designation may be restricted by Guideline D-10. Guideline D-10 cited IAS 39.9(b)(i) and (ii) as acceptable reasons for using the fair value option. Under (b)(i), the fair value option can be used if it can be proven that doing so eliminates or significantly reduces an accounting mismatch resulting from measuring assets and liabilities or the associated gains and losses on different bases. It is important to note that the reference in this item is to "assets" and "liabilities" (which include policy liabilities).[14] Under (b)(ii), the fair value option can be used if the institution has a documented risk management strategy to manage the group of financial instruments together on a fair value basis and can demonstrate that significant financial risks are eliminated or significantly reduced. OSFI includes policy liabilities under the term "financial instruments." It would be noted that both (i) and (ii) must also have fair values that are reliable.

Where the investment portfolio used to derive the discount rate applicable to the calculation of policy liabilities has all assets classified as held-for-trading or fair value option, the discount rate used will reflect a market yield. This will increase the volatility of the policy liabilities relative to the pre-CICA 3855 accounting standards. To the extent that cash flows of the policy liabilities are matched to the cash flows of the supporting assets, the gains or losses in the assets will be offset by gains or losses in the policy liabilities.

The tables below contrast the impact on the financial statements where all debt securities invested assets are classified as held-for-trading or fair value option and market interest rates increase or decrease.

[14] CICA 3855.07(d) and (e) indicate that insurance policy liabilities are not considered financial instruments within the scope of the new standards.

Market Rates INCREASE

Held-for-trading debt securities	Assets	Liabilities	Total
Invested Assets Values	↓		
Discount Rate for Actuarial Liabilities		↑	
Actuarial Liabilities		↓	
Net Income	↓	↑	depends
Other Comprehensive Income	no effect	no effect	no effect
Equity	↓	↑	depends

Market Rates DECREASE

Held-for-trading debt securities	Assets	Liabilities	Total
Invested Assets Values	↑		
Discount Rate for Actuarial Liabilities		↓	
Actuarial Liabilities		↑	
Net Income	↑	↓	depends
Other Comprehensive Income	no effect	no effect	no effect
Equity	↑	↓	depends

3.1.4 Asset Liability Mismatch

There are situations when the value of the policy liabilities does not respond completely to changes in the value of the matching assets. This is generally the case where the cash flows of the assets and liabilities do not match. For example, management may decide to invest in assets with terms longer than the term of the liabilities, with the intention to use cash available from issuing new policies to handle immediate cash needs. In these cases, the change in the policy liabilities during a period may not match the change in the value of the supporting assets. This situation is applicable regardless of the asset categorization. However, the actuary would be aware that the asset classification may also create an income statement mismatch (see Section 3.1.2).

3.2 Valuation of Policy Liabilities

Although SOPs for discounting policy liabilities have not changed, the new standards impact the actuary's valuation process as discussed below.

3.2.1 Selection of Discount Rate

SOP paragraph 2240.01 states, "The expected investment return rate for calculation of the present value of cash flow is that to be earned on the assets which support the policy liabilities. It depends on the method of valuing assets and reporting investment income ...". This SOP requires the use of a portfolio yield rate to determine the present value of the cash flows.

Section 4.1 of the July 2005 CIA educational note, *Discounting* presents the determination of the portfolio yield rate. It states: "A portfolio yield rate is the internal rate of return (IRR), which when applied to the cash flows, produces the book value at a future date of the corresponding assets. The book value of an asset may be the market value, the amortized value, or such other value consistent with Canadian generally accepted accounting principles."

The process for selecting the discount rate has not changed with the new asset classifications and measurement. The determination of the book value of an asset which

supports the policy liabilities may change, which will, in turn, affect the book yield[15] for that asset. Once the classifications are established for all assets that support the policy liabilities, the process for determining the portfolio yield is consistent with previous practice.

The book value of an asset at amortized cost is generally predictable and the associated yield rate generally stable. As such, pre-CICA 3855, the selection of the discount rate was likely reviewed only on an annual basis by the valuation actuary. Under the new standards, it is expected that the actuary would review the market value of the supporting assets and determine the associated discount rate when performing quarterly valuations due to the potential for greater swings in yields based on market value.

It is also likely that the fair value of supporting assets may not be available on a timely manner and the actuary may have to use a market discount rate based on market values prior to fiscal quarter-end (for example, November market values for a December 31 valuation). If a significant change in the market occurs, the actuary would reassess the portfolio yield rate and the selected discount rate based on actual assets as at the fiscal quarter-end.

In addition to the effect on the selected discount rate, the actuary would consider the implication of these changes on the selection of the margin for adverse deviations (MfAD) and the resulting provision for adverse deviations (PfAD) for investment return rates. SOP paragraph 1740.04 states, "The amount of that provision would take account of the effect of the uncertainty of the assumptions and data for the calculation on the financial security of those affected by the calculation ..."

The selection of an appropriate discount rate affects all policy liabilities including premium liabilities. According to SOP paragraph 2230.01, "The amount of the premium liabilities (after deducting any deferred policy acquisition expense asset) would be equal to the present value, at the balance sheet date, of cash flow on account of premium development and of the claims, expenses, and taxes to be incurred after that date on account of the policies in force at that date or an earlier date."

3.2.2 Volatility Considerations

As the selection of the MfAD continues to be governed by SOP, the actuary is reminded that SOP paragraph 1740.43 states, "A larger margin for adverse deviations (compared to the best estimate assumption) is appropriate if...the occurrence of the event assumed is more subject to statistical fluctuation." The actuary is further reminded that a change in discount rate affects not only the present value of the liabilities but also the absolute value of the PfAD.

Regarding disclosure of the volatility caused by the changing discount rates, actuaries would refer to the March 2003 CIA educational note, *Evaluation of the Runoff of Claims Liabilities when the Liabilities are Discounted in Accordance with Accepted Actuarial Practice*. The March 2003 educational note states, "For the purposes of the appointed actuary's report, it would be useful to identify the components of the runoff (i.e., the

[15] Book yield is used herein to describe the rate which equates the statement value of an asset to its future cash flows. This yield will differ from the pre-CICA 3855 measure of book yield that is based on purchase price.

contribution of the undiscounted claim liabilities, changes in the discount rate, and changes in the provision for adverse deviations)."

The July 2005 CIA educational note, *Discounting* states, "Assets supporting net policy liabilities are sometimes segregated from assets supporting capital and surplus. If so, it is common practice to assume that a subset of an insurance company's assets,…such as equities, would be matched to its capital and surplus. Consideration would also be given to the company's policy regarding asset liability matching." The March 2003 CIA educational note, *Evaluation of the Runoff of Claims Liabilities when the Liabilities are Discounted in Accordance with Accepted Actuarial Practice* addresses calculation of the runoff if assets are allocated between liabilities and equity.

3.2.3 Future Income Tax

Classification of assets introduced by CICA 3855 may have tax implications to be considered by the actuary. In particular, CICA 3855 may create tax timing differences that the actuary may need to model and measure as part of the valuation of policy liabilities (see the July 2005 CIA educational note, *Consideration of Future Income Taxes in the Valuation of Policy Liabilities*).

3.2.4 Other Issues

It is recognized that for some companies, policy liabilities are estimated prior to the actual close of the accounting period (via forecasting or rolling forward results to the end of the accounting period) in order to be able to complete the valuation on a timely basis. Due to the potential for greater swings in yields based on market value, additional uncertainty may arise in this process due to the necessity of estimating the fair value of supporting assets (and hence, the market value discount rate). The actuary would reassess the portfolio yield rate and the selected discount rate based on actual assets as at the fiscal year-end and take action as needed.

If there are discount rate changes after the initial assessment of the maximum deferred policy acquisition costs (DPAC), the actuary would determine the impact on the maximum DPAC. Particular attention would be paid when the discount rate has decreased, as this will increase the premium liability, decrease future anticipated investment income, and decrease the maximum DPAC, which may create a premium deficiency.

The integrity of the policy liability data derived from the policy/claims administration systems is not likely to be affected by fair value accounting for assets, although it may become more difficult to validate the statement values of assets under CICA 3855. It may also be more challenging to confirm the completeness and accuracy of the asset data post-CICA 3855. There are at least two complications:

- Pre-CICA 3855, there was a one-to-one mapping between asset type and accounting measurement. This is no longer the case post-CICA 3855. The designation (held-to-maturity, available-for-sale, held-for-trading, or fair value option) of every asset is critical.
- Book yields may now be much more variable from period to period. Simple continuity checks on the change in the book yield of the matching portfolio may no longer suffice as an adequate check on reasonableness.

3.3 Dynamic Capital Adequacy Testing (DCAT)

In light of the volatility associated with market interest rates and the associated impact under the new standards on discount rates used for discounting of policy liabilities, it is expected that adverse scenarios relating to interest rates may have a larger impact on projected results.

Modeling key elements of financial statements is normally required to test the capital adequacy of the insurer under the base scenario and adverse scenarios. Asset modeling will require more attention from actuaries, particularly the categorization of assets and changes in asset characterization among different scenarios.

Also, models will have to consider the new layout of financial statements, notably with respect to potential changes to the statement of income and the introduction of other comprehensive income, as correct interpretation of these will become essential in assessing an insurer's financial condition.

Finally, as discussed in Section 3.2.3, the classification of assets introduced by CICA 3855 may have tax timing differences implications that the actuary may need to model and measure as part of DCAT (refer to the July 2005 CIA educational note, *Consideration of Future Income Taxes in the Valuation of Policy Liabilities* for further information).

4. DETAILED DISCUSSION OF CICA 3855 AND 1530

As indicated in Section 1, the new standards are effective for annual and interim periods in fiscal years beginning on or after October 1, 2006. The new standards align Canadian GAAP accounting with both US GAAP and IFRS with respect to the recognition and measurement of financial instruments and the concept of comprehensive income.

It is important to realize that these changes apply to all entities: public, private, and government; for profit and not-for-profit; financial and non-financial; and large and small entities.

These new standards focus on recognizing the value of financial instruments in the balance sheet and the associated changes in their value in financial statements. While a financial instrument is defined as "a contract that creates a financial asset for one party and a financial liability or equity instrument for the other party," it is important to note that insurance policies (with the exception of certain financial reinsurance) will not be classified as financial instruments. Specifically, P&C insurance policies will continue to be accounted for in accordance with *Accounting Guideline AcG-3 – Financial Reporting by Property and Casualty Insurance Companies*.

4.1 General Description

4.1.1 CICA 3855, Financial Instruments – Recognition and Measurement

CICA 3855 expands on CICA 3860, *Financial Instruments – Disclosure and Presentation*. CICA 3855 describes when to recognize a financial instrument on the balance sheet and at what amount, and specifies how to present related gains and losses. These changes bring Canadian GAAP reporting in line with both IFRS and current US GAAP.

In responding to the issue of "at what amount," there is general agreement internationally on six broad measurement base alternatives:[16]

- Historical cost;
- Current cost (reproduction cost and replacement cost);
- Net realizable value;
- Value in use;
- Fair value; and
- Deprival value.

CICA 3855 was developed based on the IFRS contention that fair value is the most relevant measurement basis for a financial instrument provided that the fair value can be reliably measured. The rationale is that fair value "reflects market risk preferences and market expectations with respect to the amounts, timing and uncertainty of future cash flows."[17] Further, fair value reflects the current expectations of the market with respect to the financial instrument's future cash flows discounted at the risk-adjusted rate of return available in the market place.

Fair value is easily determined when an active and liquid market exists for a financial instrument. However, when an active and liquid market does not exist, measuring the fair value is more complex and subject to uncertainty. IFRS considers a four-level measurement hierarchy:[18]

- Estimates of fair value
  - Level 1 – observable market prices, including market-based adjustments
  - Level 2 – accepted valuation models or techniques; all significant inputs are consistent with those that market participants can be expected to use
- Substitutes for fair value[19] (when fair value cannot be reliably estimated using Level 1 or 2)
  - Level 3 – current cost (i.e., reproduction cost and replacement cost), with the possibility of substituting historical cost (which will likely often be a substitute)
  - Level 4 – models and techniques that use entity inputs

[16] See the IASCF Nov. 2005 Discussion Paper "Measurement Bases for Financial Accounting – Measurement on Initial Recognition," prepared by the staff of the AcSB. From an accounting perspective, present value is a measurement technique applicable to several of the listed measurement bases. It is not a measurement basis itself and, therefore, not included in the list.

[17] See AcSB's "Fair Value, Historical Cost, Replacement Cost...How Should Assets and Liabilities be Measured on Initial Recognition?"

[18] Ibid.

[19] Substitutes for fair value are not fair value and are not described as such in CICA 3855.

4.1.2 CICA 1530, Comprehensive Income

CICA 1530 introduces the concept of other comprehensive income as a temporary presentation of certain gains and losses outside of net income, and comprehensive income as a change in the value of net assets that is not due to owner activities (investments or distributions). Comprehensive income is the sum of net income and other comprehensive income. These new financial statement accounts are a consequence of the introduction of the new standards. The new standards speak only to the presentation of the results; CICA 3855 specifies whether and when an item is recognized in comprehensive income.

Changes in other comprehensive income will flow directly through equity on the balance sheet according to CICA 3250; *surplus* is amended and renamed *equity*. Equity is expanded to show not only retained earnings, but also *accumulated other comprehensive income* and *accumulated comprehensive income* (the latter equal to the sum of retained earnings and accumulated other comprehensive income).

4.2 Application of Sections CICA 3855 and 1530

All financial instruments are recognized when the entity becomes a party to the contract creating the instrument and must be classified into one of the categories described below. These categories determine how the instruments are measured and where gains and losses are recognized. In some cases, more than one category can apply dependent upon the use of the financial instrument and its characteristics, in which cases, a choice of category is made. Care must be taken where a choice is available since it is rarely possible to reclassify instruments.

All financial instruments acquired or assumed in an arm's length transaction are to be initially measured at fair value (usually based on the consideration given or received[20]), regardless of the category selected. However, subsequent measurement and the treatment of gains and losses varies by category, so these factors would be considered in determining the category for a particular financial instrument, if a choice of category is available.

Subsequent measurement may occur through revaluation, recognition (or reversal) of impairment loss, or re-measurement at each accounting period under a mark-to-market (i.e., fair value) approach. Re-measurement would be consistent (i.e., the source of prices would be consistent).

For the purposes of recognizing gains and losses, a financial instrument is *derecognized*[21] when it is removed from the balance sheet.

4.2.1 Categories of Financial Instruments

This section describes in detail the categories for financial instruments that are summarized in the following table.

[20] The new standard provides guidance on determining fair value. In particular, where a current price is not available, future cash flows are discounted using appropriate discounts for the term of each cash flow.

[21] "Derecognition" is a defined term in CICA 3855.19(m).

Summary of Requirements for Measurement and Recognizing Gains and Losses

	Category	Initial Measurement	Subsequent Measurement	Gains and Losses
Assets	Loans and Receivables	Fair Value	Amortized cost using the effective interest method	Recognized in net income when the asset is derecognized impairment write-downs and foreign exchange translation adjustments recognized immediately in net income
	Held to Maturity Investment			
	Available for Sale	Fair Value	Fair Value*	Recognized in other comprehensive income; transferred to net income when the asset is derecognized; impairment write-downs recognized immediately in net income
	Held for Trading	Fair Value	Fair Value	Recognized immediately in net income
Liabilities	Other Liabilities	Fair Value	Amortized cost using the effective interest method	Recognized in net income when the liability is derecognized; foreign exchange translation adjustments recognized immediately

*Equity instruments that do not have a quoted market price in an active market are measured at cost

Note that the fair value caveat for subsequent measurements in the table above (i.e., that equity instruments that do not have a quoted market price in an active market are measured at cost) applies only if the equity is categorized as available-for-sale – it does not apply to equity categorized as held-for-trading.

4.2.1.1 Financial Assets – Loans-and-Receivables

CICA 3855.19(h) defines this category as follows:

> Loans and receivables are non-derivative financial assets resulting from the delivery of cash or other assets by a lender to a borrower in return for a promise to repay on a specified date or dates, or on demand, usually with interest...other than:
>
> i. debt securities...; and
>
> ii. loans and receivables that the entity, upon initial recognition, designates as held-for-trading or as available-for-sale.

Subsequent measurement of this category of assets is completed on an amortized cost basis using the effective interest method.

Gains and losses are recognized in net income when an asset in this category is derecognized. Impairment write-downs and foreign exchange translation adjustments are recognized immediately in net income.

Loans-and-receivables may alternatively be classified as held-for-trading or available-for-sale. However, as indicated in item (ii) in the list above, reclassification to loans-and-receivables after initial classification to held-for-trading or available-for-sale is not allowed. Careful consideration and comparison of the subsequent measurement and treatment of gains and losses for these other two categories would be given before a final decision on categorizing individual loans-and-receivables.

4.2.1.2 Financial Assets – Held-to-maturity Investments

CICA 3855.19(g) defines this category as follows:

> Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity...other than:
>
> i. those that the entity, upon initial recognition, designates as held for trading;
>
> ii. those that the entity designates as available-for-sale; and

iii. those that meet the definition of loans and receivables.

To qualify for this category, the financial asset *must* have cash flows that are fixed (i.e., the maturity date is fixed and any coupons/payments are fixed or determinable). In addition, the entity must have the positive intention and ability to hold the asset to maturity. In fact, if there are *not insignificant* sales of assets in this category before maturity, the entity must reclassify *all* financial assets so categorized to the available-for-sale category unless the reason for the sale is outside the entity's control. Furthermore, if a reclassification takes place, the entity will not be allowed to use this category again for a two-year period.

Subsequent measurement and the treatment of gains and losses for this category are the same as assets categorized as loans-and-receivables. Subsequent measurement is completed on an amortized cost basis using the effective interest method. Gains and losses are recognized in net income when an asset in this category is derecognized. Impairment write-downs and foreign exchange translation adjustments are recognized immediately in net income.

Due to the reclassify consequence associated with a significant sale of assets in this category before their maturity, much care would be taken in assigning assets to this category. Alternative categories for assets that otherwise qualify for held-to-maturity are held-for-trading and available-for-sale. Careful consideration and comparison of the subsequent measurement and treatment of gains and losses for these other two categories would be given before a final decision on categorizing individual investments as held-to-maturity.

4.2.1.3 Financial Assets – Available-for-sale

CICA 3855.19(i) defines this category as follows:

> Available-for-sale financial assets are non-derivative financial assets that are designated as available-for-sale, or that are not classified as loans and receivables, held-to-maturity investments, or held-for-trading.

This category for financial assets can be thought of as the *all other* since it captures all financial assets not classified under the other three categories of financial assets.

Subsequent measurement of this category of assets is completed on a fair value basis. Equity instruments that do not have a quoted market price in an active market are measured at cost.

Gains and losses including foreign exchange translation adjustments (see CICA 3855.78) are recognized in other comprehensive income and transferred to net income when an asset in this category is derecognized. Impairment write-downs are recognized immediately in net income.

Available-for-sale and held-for-trading are the only two categories where the subsequent measurement base is fair value; all other categories use amortized cost. However, the subsequent measurement values under available-for-sale and held-for-trading differ where the financial asset is an equity instrument that does not have a quoted market price in an active market. Under available-for-sale, the equity would be subsequently measured at cost, whereas it would be measured at fair value under held-for-trading.

Available-for-sale is the only category in CICA 3855 that uses the other comprehensive income segregation of income.

4.2.1.4 Financial Assets and Financial Liabilities Held-for-Trading[22]

CICA 3855.19(f) defines this category as follows:

> A financial asset or financial liability held-for-trading is a financial asset or financial liability that meets either of the following conditions:
>
> i. it is not a loan or receivable...and is:
> acquired or incurred principally for the purpose of selling or repurchasing in the near term;
>
> part of a portfolio of identical financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit taking; or
>
> a derivative, except for a derivative that is a designated and effective hedging instrument...; or
>
> ii. it is designated by the entity upon initial recognition as held-for-trading. Any financial instrument within the scope of this Section may be designated when initially recognized as held-for-trading...except for:
>
> financial instruments whose fair value cannot be reliably measured...; and
>
> financial instruments transferred in a related party transaction that were not classified as held-for-trading before the transaction.
>
> Paragraph 3855.80 precludes reclassification of a financial instrument into or out of the trading category while it is held or issued.

Item (i) above is the *original* intent of this category captured in the original International Accounting Standard IAS 39, *Financial Instruments: Recognition and Measurement.* IAS 39 was amended in December 2003 to introduce the option that permits entities to designate any financial asset or financial liability for measurement at fair value (with gains and losses recognized immediately in net income). This amendment has become known as "The Fair Value Option" and is reflected in item (ii) of the new standards. This first amendment effectively allowed all financial instruments to qualify for inclusion in this category.

IAS 39 was further amended in June 2005 with IAS 39.9(b). This addition placed restrictions on financial instruments that qualify for this category (see next paragraph). However, this further restriction did not find its way into CICA 3855.19(f) (ii).

On June 22, 2006, OSFI issued three documents related to their Guideline D-10. Guideline D-10 specifically focused on the fair value option indicated under CICA 3855.19(f)(ii) and indicated that OSFI expects federally regulated financial institutions

[22]AcSB did not to use the internationally accepted name for this category – "Fair Value Through Profit or Loss." The internationally accepted name better reflects the fact that all financial instruments – not just those held-for-trading – can be considered under this category (with restrictions as per IAS 39.9(b)). Note that under CICA 3855.35, "*an entity may appropriately use labels other than held-for-trading, held-to-maturity, loans and receivables and available-for-sale.*"

will use the fair value option only when doing so results in more relevant information, because either:[23]

i. it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on a different basis; or

ii. a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis...

OSFI goes on to state:

> For IAS 39.9(b)(i), institutions may apply the Fair Value Option under this criterion if (a) consistent with a documented risk management strategy, it eliminates or significantly reduces the measurement or recognition inconsistency of measuring financial assets or liabilities together on a different basis, and (b) the fair values are reliable.
>
> For IAS 39.9(b)(ii), institutions may apply the Fair Value Option under this criterion if (a) the institution has a documented risk management strategy to manage the group of financial instruments together on a fair value basis and can demonstrate that significant financial risks are eliminated or significantly reduced,[3] and (b) the fair values are reliable.

These additional criterions are more restrictive than 3855.19(ii) and apply to insurers' assets and policy liabilities. However, Guideline D-10 also points out that legislation allows OSFI to specify accounting principles; since classification by category is a choice, Guideline D-10 amounts to a narrowing of options available under CICA 3855 and, hence, is within the range of practices permitted under Canadian GAAP.

Subsequent measurement of this category of assets and liabilities is completed on a fair value basis. Gains and losses are recognized immediately in net income.

OSFI Guideline D-10 applies additional guidance on this category. Consideration would also be given to the relative merits associated with differing measurement basis for subsequent measures and the treatment of gains and losses. In particular, held-for-trading and available-for-sale are the only two categories where the subsequent measurement base is fair value; all other categories use amortized cost. Furthermore, held-for-trading is the only category where all gains and losses are recognized immediately in net income.

[23] This is quoted in the D-10 Guideline as a part of IAS 39.9(b).