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## **M Financial Commentary on Divergent Earnings Reported Between Canada and United States**

Over the past few weeks, insurance companies reported third-quarter financial results. Generally, Canadian insurers have been reporting losses while U.S. insurers have been reporting gains. This is primarily the result of the use of different accounting regimes, which is creating very different earnings outcomes.

Canadian insurers report earnings based on International Financial Reporting Standards (IFRS-C). U.S. insurers report earnings based on Generally Accepted Accounting Principles (U.S. GAAP). These different accounting regimes provide very different pictures of financial conditions as market indicators change.

For example, when equity markets or interest rates decline (and all other factors are equal), U.S. GAAP can help companies with similar risks post more favorable results than companies reporting under IFRS-C.

The reverse is also true. When equity markets or interest rates increase (and all other factors are equal), IFRS-C can help companies with similar risks post more favorable results than companies using U.S. GAAP companies.

The primary reason is that U.S. GAAP and IFRS-C have very different approaches to measuring policy liabilities. In a rising equity market, the fair-value construct of IFRS-C immediately recognizes the effects of equity market gains in both assets and policy liabilities. With U.S. GAAP there is a lag effect as equity market changes are accounted for through a combination of fair-value (assets) and book-value accounting (policy liabilities). Rising interest rates under IFRS-C could lead to more favorable results because the rate used to discount policy liabilities also increases, resulting in a reduction in policy liabilities that could be reported in earnings as a release in reserves.

As an example of the potentially divergent results by accounting regime, Manulife Financial Corporation (MFC) reported a third quarter 2011 loss of \$1.3 billion on an IFRS-C basis due to lower interest rates and equity market performance. However, if the third quarter results were reported on a U.S. GAAP basis, MFC would have reported a net gain of \$2.2 billion.

It should be noted that when rating agencies analyze the financial strength of an insurer, their primary objective is to determine its ability to pay claims under the terms of its insurance policies. This is independent of an insurer's particular accounting regime. Therefore, rating agencies seek to understand the essential biases inherent in the accounting assumptions used in an insurer's financial reporting as they aim to develop an informed perspective regarding a company's ability to withstand comparable levels of stress.

Furthermore, rating agencies seek to understand how a company's particular accounting reacts (or does not react) to continuously changing market conditions. Each accounting regime has its advantages and disadvantages that can vary depending on the particular economic environment and an insurer's specific situation.

M Financial will continue to monitor this topic and will provide updates as further developments occur. For more information, please contact:

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