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## Forward Focus

# Insurance and wealth management



### Welcome to the August edition of Forward Focus.

The recent months have seen substantial developments in a number of areas set to impact the insurance and wealth management industry.

Firstly, the Financial Adviser Regulation is aiming to change the standard of excellence in the wealth management space. The 'winners' will likely be those who recognise that the sustainable performance standard for market conduct is not 'minimum compliance', but rather 'best practice'. And those organisations who view the upgrade to best practice as an opportunity to drive value throughout the business will be the ones who reap the rewards. In this edition we dig in behind the Financial Adviser Regulations to highlight two separate, but related, critical issues that business leaders should focus on as they reinvigorate their businesses, regain consumer confidence and position sustainably for future growth.



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In the accounting space, the IASB released a long awaited Exposure Draft for IFRS 4, which will be shaping the future of insurance reporting and will determine what businesses may look like to their investors. We look at what the new standard means for your business.

We also highlight the topical issues of detecting fraud in the insurance sector, and the business implications from further developments in the GST rate rise.

If you have any questions or want to discuss these topics further, please feel free to contact me or one of the financial services team. As always, we welcome your feedback and suggestions for other topics you would like us to cover.

Kind regards

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Partner

# Financial Adviser Regulations

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How is your organisation approaching the Financial Adviser Regulations – as a compliance exercise or an important opportunity to build a better business?

Many affected businesses will be well advanced in developing or revising their business strategy, in so far as it impacts the provision of financial advice and the personnel charged with providing this advice to clients / customers, and if required, preparing their Adviser Business Statement (ABS).

It is tempting, given the significant amount of work required and tight timeframes, to launch head-long into what needs to be done, overlooking some of the more

fundamental issues and drivers which will need to be addressed early if one's investment is to be fully realised and progressively higher public expectations met. In this regard management's vision and focus should be shaped and anchored firmly by the substance of public expectations.

### Primary objective and areas of focus

The New Zealand regulators have advised that their supervisory framework is expansive and will not focus solely on advisers meeting core obligations. Instead, core obligations must be supplemented by a culture of professionalism; this will ensure that meeting those obligations is not seen as merely a matter of compliance but more as a matter of best practice in providing a financial adviser service.

The spirit of the new regulations is clear - the overarching purpose of the Act is to promote the **sound** and **efficient** delivery of financial advice, and to encourage public confidence in the **professionalism and integrity** of financial advisers.

This simply stated objective highlights two separate but related areas of focus, each warranting particular attention if firms are to capitalise on this opportunity and have a successful and growing business in future:

### Professionalism – leadership and culture

Recent events have reinforced the truth that one cannot run a successful adviser or fiduciary business if one is not trusted. The business case for ethical and honest behaviour has been convincingly made.

In their latest "U.S. Financial Services Trust Barometer" for 2010, Edelman clients surveyed identified the top three factors in a firm's reputation:

- Has transparent and honest business practice (82% of survey respondents)
- Is a company I can trust (80%)
- Offers high quality products and services (79%)

Edelman's empirical evidence also reaffirms that financial service customers are prepared to pay a premium for the same products to firms they trust.

Leadership and culture lie at the heart of embedding a professional attitude, approach and practices in all employees increasing public confidence in financial advisers. Tamar Frankel, professor of law and ethics at Boston University, cites that the necessary ingredients for changing the culture lie with leadership and framed as three prerequisites: (1) leadership must want its company to be honest and ethical, (2) leadership must convince other leaders to do the same and (3) honesty and ethics must be enforced.

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# Financial Adviser Regulations

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Whether you intend qualifying as a Qualifying Financial Entity (QFE) (and even if not), it is worth reflecting on the substance of your firm's culture, governance and compliance arrangements:

- Are these practices currently lived out daily in your firm (does your firm meet Frankel's 3 prerequisites and demonstrably meet the Code of Professional Conduct in the case of Authorised Financial Advisors?)
- Has your FAA program been embraced fully in the spirit of what is needed and are you confident that your firm's leadership have, from the outset, sufficiently evidenced this by setting the right 'tone at the top'.

### Efficient and effective delivery of financial advice

The regulators have advised that their supervisory framework is intended to accommodate different ways of delivering financial advice to ensure business models and advice delivery methods are not unduly influenced by it i.e. the framework is neutral across models and methods.

Notwithstanding, in responding to the regulatory requirements firms should use this as an ideal opportunity to review and validate their current and prospective business models in line with broader evolving

industry changes (regulatory and competitive) and their own value propositions. In this regard it is worth noting the intensification in regulatory focus on firms' conduct with consumers coming out of jurisdictions similar to our own, notably the UK (*FSA's Approach to Consumer Protection: Speech by Sheila Nicoll, Director of the Conduct Policy Division – 24/6/2010*).

Has your firm given sufficient consideration to:

- The substance (as opposed solely to the form) of the regulator's own guidance materials (e.g. QFE ABS Guide issued by the Securities Commission)
- Your organisation's strategic view on how the intentional tiering in the Act (between service provision across the various potential providers) could impact your business now and in the future? E.g. your value proposition to different customer segments
- A methodology to translate your chosen strategies into an optimal target operating model design as the basis for a detailed business case and roadmap for implementation.

Interrogating your program in the manner suggested should help inoculate against the risks, helping further build the right culture, in turn delivering the attendant rewards.

		Authorised Financial Adviser (AFA)	QFE Adviser	Registered Individual	Registered person (individual or entity)
Investment Planning Services		✓			
Personalised financial advice to a retail client	Category 1 product: QFE is <u>not</u> the product provider	✓			
	OR Category 2 product: QFE is the product provider	✓	✓		
Personalised discretionary investment management service to a retail client	Category 2 product	✓	✓	✓	
Class service to a retail client		✓	✓	✓	✓
Financial Adviser service to wholesale clients		✓	✓	✓	✓



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# Insurance Accounting – IFRS 4 For Insurers

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### IFRS 4 for insurers

On 30th July 2010 the International Accounting Standards Board (IASB) released an Exposure Draft (ED) for IFRS 4 with a comment period up to 30th November. The US Financial Accounting Standards Board (FASB) has been part of the IASB's project and most of the conclusions reached by the IASB and FASB are consistent. The FASB intends to publish its discussion paper during the 3rd quarter of 2010. The IASB intends to issue a final standard on or before 30th June 2011 with implementation from 1st January 2013.

At a time when insurers in New Zealand are focused on getting ready for the enactment of the New Zealand Insurance Bill, they now also have to consider what their business may look like, and what changes they may need to make to cope with the long awaited global insurance accounting standard. The insurance contracts standard has been on project list of the IASB since before New Zealand adopted IFRS in 2007. While adoption of IFRS was not a simple process for business in NZ, for insurers the impact of the change was eased by NZ IFRS 4 effectively replicating the requirements of the previous NZ GAAP FRS 34 and 35. The ED IFRS 4 changes this and introduces principles that will apply uniformly across all forms of insurance: life, health and general and to all insurers who prepare financial statements in accordance with IFRS and potentially US GAAP.

### So what does ED IFRS4 require?

In many respects the changes proposed by ED IFRS 4 will have less impact on NZ (and Australian) insurers than for those operating in other jurisdictions – but that doesn't mean things stay the same for NZ. Issue 17 of our [Insurance Accounting Newsletter](#) discusses in detail the technical changes proposed. The most significant of these changes are:

- The proposed "building blocks" approach to the measurement of insurance liabilities. The three building blocks being:
  - Probability weighed estimates of future contract cash flows
  - Discount rate to allow for time-value of money
  - Margin to allow for uncertainty and future profits
- Only incremental acquisition costs incurred will be included in the liability measurement. All other acquisition costs which currently meet the definition within Deferred Acquisition Costs (DAC) are likely to be required to be expensed as incurred.
- Increased judgement required in respect of the discount rate applied. While the rate applied should still be based on the risk free rate (with some exceptions), this needs to be adjusted with an illiquidity premium calibrated on the illiquidity of the contractual cash flows.

- Increased care and judgement needed in the choice of realistic assumptions as future changes to assumptions will be capitalised in the Income Statement.
- The presentation of the Statement of Comprehensive Income moves away from the more traditional premiums earned/liabilities incurred presentation to a "summarised margin" approach. It is proposed that the Statement of Comprehensive Income would have a minimum of five lines being:
  - Underwriting margin
  - Gains and losses on initial recognition
  - Non-incremental acquisition expenses
  - Experience adjustments and changes in estimates
  - Interest expense on the insurance liabilities

### What should you be doing now?

- Consider if you want to make any comment on the proposal. The comment period for this ED closes 30 November 2010.
- Assuming the ED passes into the final standard largely unchanged, start to consider what system changes will be required to access the information required to report. Will you need to alter your general ledger to accommodate the new requirements? If so, what data will be required?
- On transition to the revised standard insurers will need to restate insurance liabilities. This may include writing off DAC assets that don't meet the revised definition and restating all in-force contracts using the "building blocks" measurement approach. What will this do to your business and how will your balance sheet (and future profitability) look? How will you communicate/explain these changes to your shareholders and/or policyholders?
- Start to model how these changes may affect your reporting under the New Zealand Insurance Bill. The Bill currently refers to NZ IFRS 4 in a number of places. How will the changes proposed in this ED impact? Will it alter views on the financial condition or measurement of solvency? Consider how this will affect your reporting for tax purposes.

### Final thoughts

Through the development of this ED the IASB has reconsidered every aspect of insurance accounting; from the definition to the measurement to the presentation and disclosure. As a result almost every insurance company will experience a degree of change in their financial statements. If the transition to NZ IFRS taught us anything, it was that the earlier you start planning for change, the less impact that change has on the business. While 2013 seems a long way off – three years is not long if any system changes are required. Preparation and early modelling will help avoid any unexpected surprises.



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# Detecting fraud

## The power of visualisation

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Banking and insurance businesses are inherently attractive targets for fraudsters. The anonymity offered by having customers measured in tens of thousands provides fertile ground for mortgage frauds, credit card frauds and fraudulent insurance claims.

The large databases that banks and insurance companies use to manage the volume of customers and transactions provide the fraudsters anonymity, but also a powerful tool for businesses to detect fraud.

Most banks and insurance companies in New Zealand use data mining techniques to identify anomalies and potential fraud, such as:

- Customers and staff with shared details (bank account, address, phone number, etc)
- "Bad debts" with common lawyers and valuers
- Payments to different customers being made to the same bank account (from payment batches)

These sorts of tests routinely identify fraud. However the output from standard data mining techniques is tables of data, which can be cumbersome to review.

Our past encounters have shown investigative visual analysis ("VA") to be a powerful tool to catch fraudsters. VA uses charts and diagrams to uncover hidden patterns in large amounts of data and allows investigators to visualise relationships and patterns not readily apparent from tables of data.

### Customers with shared details

Many bank and insurance frauds involve an element of identity fraud. However, it takes considerable effort and increased cost to successfully create a false identity with no links to other identities, false or genuine.

Unsurprisingly, data mining for customers (and staff and suppliers) with the shared details (bank accounts, address, phone numbers, Inland Revenue numbers, IP address, etc) is a rich source of information to identify fraudsters.

The traditional output from data mining is tables of data, which can be time consuming to examine. This approach will identify anomalies (e.g. two "customers" with the same bank account number), but given the volume of data typically involved may not identify "rings" (e.g. three other "customers" linked by bank account number, Inland Revenue number and address).

### Mortgage fraud

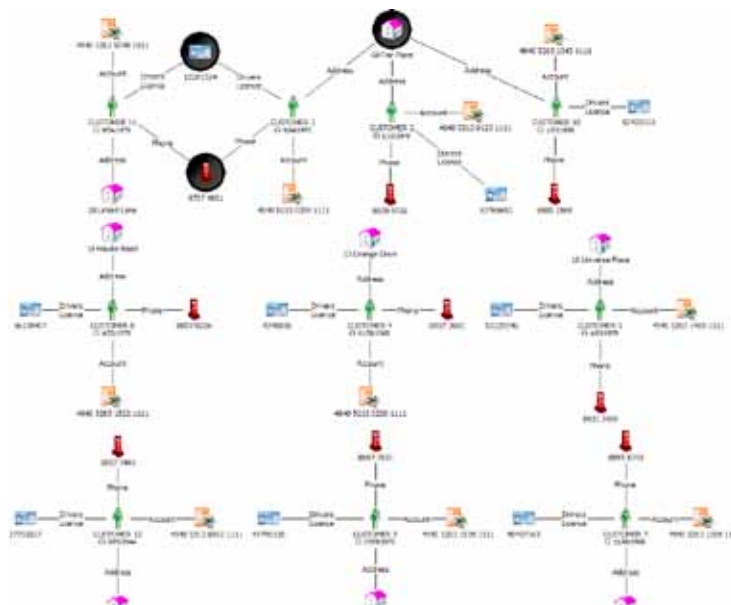
Mortgage fraud typically comes to the attention of banks in the form of a "bad debt". Mortgage frauds often use compliant lawyers and valuers as part of the process. Traditional data mining of bad debts and associated lawyers and valuers would produce a table report which is yet again harder to establish all relationships from.

Whether looking for customers with shared details or to investigate mortgage fraud, here is an example of how much easier it is to quickly identify potential fraud.

Data in table format appears as:

A/c No.	Customer Name	DOB	D/Licence	Phone	Address
4940 5263 1543 1111	CUSTOMER 10	1/03/1958	50423353	8809 2568	68 Fair Place
4940 5263 5048 1111	CUSTOMER 11	9/04/1973	12281324	9707 4891	20 Linked Lane
4940 5313 0002 1111	CUSTOMER 12	3/05/1944	27755527	8857 3492	34 Green Grove
4940 5213 0123 1111	CUSTOMER 2	1/10/1970	53788652	8808 9556	68 Fair Place
4940 5213 0205 1111	CUSTOMER 3	9/04/1972	12281324	9707 4891	68 Fair Place
4940 5213 0226 1111	CUSTOMER 4	11/08/1968	4340858	8857 3602	13 Orange Drive
4940 5263 1485 1111	CUSTOMER 5	4/03/1979	53225546	8831 3439	16 Universe Place
4940 5263 1509 1111	CUSTOMER 7	11/06/1968	48457163	8855 5743	5 Black Street
4940 5263 1522 1111	CUSTOMER 8	4/03/1979	56178407	8857 0206	16 Hawke Road
4940 5263 1539 1111	CUSTOMER 9	17/09/1972	47796535	8887 7631	92 Beach Drive

This same data in visual format appears as:



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# Detecting fraud

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### Electronic payment fraud

In our experience electronic payments can be a major area of focus for fraudsters and we have recently come across two cases involving insurance companies. Electronic payment fraud is easily committed by dishonest employees – it simply involves changing a customer or supplier's bank account number from the valid bank account number to one that the dishonest employee controls, then making the payment as per normal.

The good news is these frauds can be easily and efficiently detected by simply analysing payment batches the bank processes (analysing the master data in the accounting system will not reveal this fraud unless a log is kept of all bank account changes).

We would expect each customer or supplier to typically have one bank account (i.e. a one to one relationship). In the top left hand corner of the chart below there are three bank accounts linked to multiple suppliers (or customer).

### The power of VA

Visual analysis enables insurance companies to efficiently process large volumes of transactions and identify anomalies for investigation. There could be a valid reason for the anomaly or it could be fraud.

Our experience has shown VA to be a powerful tool in providing the following benefits:

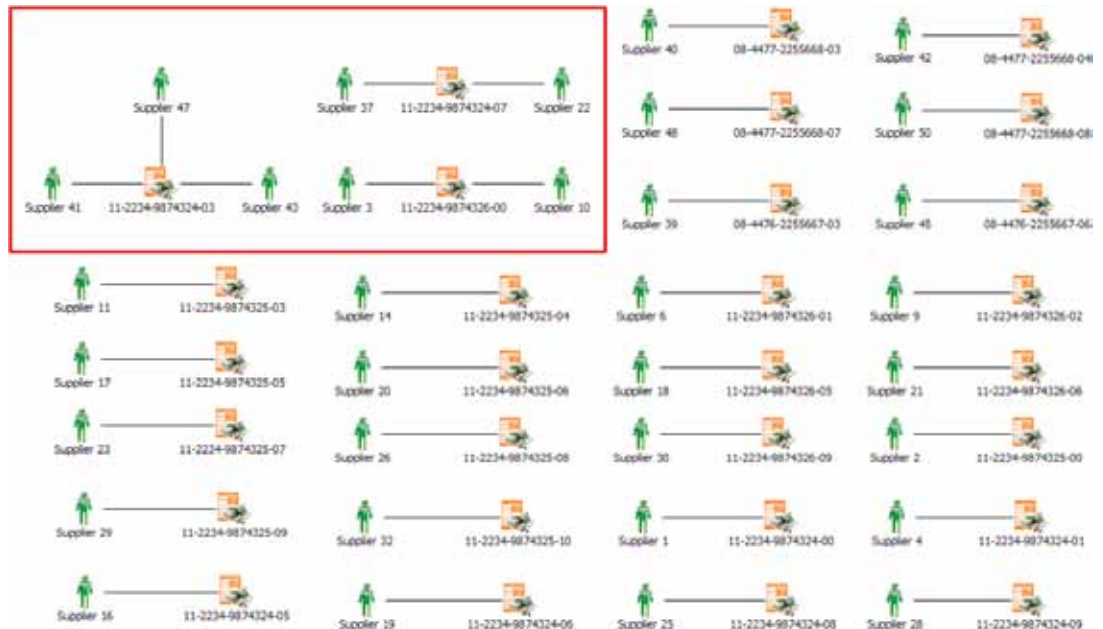
VA allows large amounts of data to be analysed quickly and efficiently.

VA shows investigators where to target their investigation and how to best allocate their time and resources.

VA charts are a 'live document' and can be continually updated as more information from various sources is received in an investigation.

VA establishes links between individuals, locations, vehicles, events, telephone numbers and other identifiers rather than relying on the investigator to establish the links manually.

VA brings clarity to often complex relationships and can be easily understood by those not directly involved in the investigation (such as lawyers or judges).



# GST update

## Recent developments

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General insurers have been busy getting ready for the GST rate rise from 1 October, although further changes are on the way in that space. Recently released GST law changes will affect the insurance industry and may allow an insurer to carry on accounting for GST at 12.5% after 1 October 2010. The amendments provide transitional "fixes" to smooth the way for the GST rate increase to 15% on 1 October.

The proposed amendment relates to "annual" contracts involving successive supplies and gives insurers the option of applying the 12.5% rate for the rest of the insured period up to the next "annual" review date (being within 13 months) provided certain criteria are satisfied. Essentially, the insurer must account for all the remaining GST in the September GST period, and GST-registered recipients can only claim back GST at 12.5%

(as the remaining supplies are treated as being made on 30 September). Insurers elect this option by filing their September GST return on this basis, and must give "notice" to its GST-registered customers by 31 October. This notice does not need to be a letter and may be an announcement on its website, etc.

The other amendment of relevance to insurers relates to subrogation payments. It allows the GST rate to remain at 12.5% for subrogation payments received on or after 1 October to the extent that the underlying claims are agreed and settled before 1 October.

We are pleased that these practical steps have been taken, albeit they may create some new problems of their own from a systems and operational perspective, which insurers would need to assess before electing into the option.



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Recently released GST law changes will affect the insurance industry and may allow an insurer to carry on accounting for GST at 12.5% after 1 October 2010.



**We hope you enjoyed the read.**

We're always keen to hear your feedback, if you have any suggestions for content or topics you would like us to explore in the newsletter please email us on [nzinfo@deloitte.co.nz](mailto:nzinfo@deloitte.co.nz)

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