

# Beyond the GAAP

No.54 – March 2012

At the end of March, the IASB updated its work plan, once again postponing the publication of documents relating to the joint projects on Financial Instruments and Leases.

In the case of Financial Instruments, publication of the Review Draft on hedge accounting and the Discussion Paper (or exposure draft, depending on the IASB's final decision) on macro-hedging have been put back to the second quarter and second half of 2012, respectively.

More surprisingly, the publication of the second exposure draft on Leases has also been postponed to the second half of 2012. This new delay has led some observers to question the IASB's ability to win acceptance for its new model and to lead this project to a conclusion within a reasonable time.

Enjoy your reading!

Michel Barbet-Massin

Edouard Fossat

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## News

### A new member at the IASB

On 19 March 2012, the trustees of the IFRS Foundation, the oversight body of the IASB, announced the appointment of Chungwoo Suh as a member of the IASB.

His mandate will take effect on 1 July 2012, for an initial term of five years, renewable once for a further three-year period.

Mr Suh currently serves as an advisor to the Korean Accounting Standards Setter (KASB). He serves as Chairman of the KASB between 2008 and 2011, during which time he led Korea's preparations to adopt IFRSs in full from 2011.

Mr Suh is also Professor of Accounting at Kookmin University, Seoul.

### ➤ The IASB updated its work plan

On 23 March 2012, the IASB once again updated its work plan to reflect the progress in its current projects. The main changes are as follows:

- General hedge accounting: the Review Draft will be published during the second quarter, but the publication of the final standard is still expected during the second half of the year;
- Macro hedge accounting: the publication of the Discussion Paper (or exposure draft, depending of the IASB's final decision) on macro hedge accounting is now expected during the second half of 2012;
- Leases: the new exposure draft on the accounting treatment of Leases is now expected during the second half of 2012;
- Annual Improvements: the exposure draft for the 2010-2012 improvements, previously expected in the first quarter, should be published during the second quarter.

Finally, the post-implementation review of IFRS 8 on Operating Segments has been officially launched (see below), while the review of IFRS 3, Business Combinations, should commence in the second quarter 2012.

### ➤ IASB to 're-open' IFRS 8

After three years of mandatory application of IFRS 8, March saw the official launch of the IASB's post-implementation review of the standard on operating segment disclosures.

It will be remembered that since 2007 the IASB's *Due Process Handbook* has established a requirement to conduct a post-implementation analysis of any applications issues in the light of experience. This post implementation review also considers any unexpected costs incurred in the application of a text.

In the particular case of IFRS 8, the IASB has decided that the review will also consider the extent to which the aim of convergence with US GAAP has been achieved, and how far this standard has improved the financial information which is published.

This is the first time that the IASB has included the official review of so recent a standard in its work plan.

We expect stock exchange regulators, who have frequently raised the difficulties experienced in applying the standard (for example, the aggregation of operating segments into reportable segments) or the requirement for additional information (such as the identity of the chief operating decision maker), to welcome this step with enthusiasm.

During its May meeting, the IASB will decide what issues should be included in a Request for Views which will be published during the second quarter of 2012.

Stakeholders will thus be offered an opportunity to give their views of the quality of IFRS 8, the IASB having decided to increase the transparency of the review process.

### ➤ An interpretation on levies charged for participation in a specific market expected soon

At the end of 2011, the IFRS Interpretations Committee considered a question on the levies due from entities participating in a specific market.

The concern relates to identifying the event which triggers the recognition of a liability for payment of these levies.

In March 2012, the Committee confirmed that it would publish an interpretation, but decided to limit the scope to levies:

- excluded from the scope of IAS 12 *Income Taxes*;
- that are non-exchange transactions (i.e. transactions in which the entity does not receive an asset or a service in exchange);
- where the levies are not subject to a revenue threshold;
- where the payment arises by law;
- where the payment is due to the occurrence of an obligating event at a specific date or arising progressively over a period of time.

The staff will present a draft interpretation for the Committee's approval at the May 2012 Committee meeting.

We will certainly keep you informed of the accounting treatment which is decided upon once the final interpretation is published.

## IFRS

### Publication of the amendment to IFRS 1 on loans received from governments at a below market rate of interest

On 13 March 2012, the IASB published an amendment to IFRS 1 dealing with loans received from governments (or similar public bodies) at below market rate of interest.

This amendment introduces a new exception to the general principle of retrospective application of IFRSs by first-time adopters. It states that first-time adopters shall apply the requirements of IAS 20 prospectively to government loans existing at the date of transition to IFRSs. This means that the first-time adopters shall not recognise the corresponding benefit of the government loan (the differential between the reduced rate and the market rate) as a government grants.

However, an entity may choose to apply the requirements of IAS 20 to government loans retrospectively if the information need to do so had been obtained at the time of initially accounting for the loans. This choice may be made case-by-case.

The amendment is mandatory for annual periods beginning on or after 1 January 2013. Earlier application is permitted.

According to the EFRAG timetable updated on 19 March 2012, the European Union is expected to endorse this amendment during the final quarter of the year.

## European matters

### EFRAG launches new study on IFRS 10

On 21 March 2012, EFRAG announced a supplementary study on IFRS 10, in the form of a questionnaire to be returned by 16 April 2012

This study is intended to determine what impact IFRS 10 will have on the consolidation scope of SPEs (Special Purpose Entities).

For more details of EFRAG's invitation to participate go to:

<http://www.efrag.org/Front/n1-921/EFrag-invites-companies-to-participate-in-a-supplementary-study-on-how-IFRS-10-will-affect-the-consolidation-of-Special-Purpose-Entities--SPEs---.aspx>

### Meeting between EFRAG and IASB to discuss the progress of the convergence work plan

On 9 March 2012, the IASB and EFRAG, accompanied by representatives of German, English, Italian and French accounting standard setters, met to discuss the progress of ongoing projects.

During this meeting, EFRAG welcomed the more measured pace of the IASB's work over the last six months, but drew the IASB's attention to the following points:

#### Complexity of the new standards:

Quoting the results of its field tests, EFRAG stressed the complexity of the new IFRSs already published (IFRS 10, IFRS 11, IFRS 13), or under preparation (Revenue Recognition), and advised the IASB to perform a review of the difficulties encountered in practice and seek way of improving the articulation of the basic principles and concepts of these standards.

#### Revenue Recognition

EFRAG confirmed its view that the onerous contract test should be conducted at contract level.

It also contested the systematic offset of advances against contract assets.

## European matters

Finally, EFRAG considered that it should be possible to allocate contingent amounts to more than one performance obligation.

EFRAG believes that all these subjects should be addressed once more by the IASB in its final deliberations

### Leases

In EFRAG's view, the IASB cannot gain acceptance of a standard that calls for the recognition of all leases in all circumstances.

EFRAG suggests, inter alia, that if the IASB intends to pursue this project, it should retain the current distinction between financing and operating leases, with some improvements.

### Financial Instruments: Classification and Measurement

EFRAG has welcomed the decision of the IASB to consider how IFRS 9 classification and measurement requirements could be improved and to give convergence with US GAAP another chance, with a willingness to avoid undue delays in the publication of the standard.

However, EFRAG has drawn the attention of the IASB to the fact that the principles-based approach to IFRS 9 should not be lost in this effort, but rather strengthened.

### Insurance contracts

EFRAG welcomed the fact that its recommendation that IFRS 9 be re-examined in the light of the development of IFRS 4 is being followed by the IASB.

Nevertheless, EFRAG reiterated that the long-awaited standard on insurance contracts should not be delayed unduly.

For more details of the main messages addressed by EFRAG to the IASB during this meeting, you can consult the report at:

[http://www.efrag.org/files/News%20related%20documents/EFrag - IASB joint meeting summary - 9 March 2012 - final.pdf](http://www.efrag.org/files/News%20related%20documents/EFrag%20IASB%20joint%20meeting%20summary%20-%209%20March%202012%20-%20final.pdf)

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## Insurance Contracts (IFRS 4 Phase II): what stage are we of the project? (part two)

The draft IFRS on Insurance Contracts is still under development after more than 10 years of work. The delay in preparing this standard reflects the divergent views expressed at various stages in the project, not least at the most recent stage: the exposure draft (ED/2010/8 Insurance Contracts) published by the IASB in July 2010.

In the February 2012 edition, *Beyond the GAAP* highlighted the history of the project under review and discussed the key points proposed in the exposure draft published in July 2010 and the main reactions to and criticisms of this project.

In this edition, we provide an up-to-date report of the main changes made by the Board since the publication of the exposure draft as a result of its redeliberations, and will present the main aspects which are at stake.

### ➤ The Board's main changes since the exposure draft

Since the release of the exposure draft, and in response to the many comments received (for more details of the principal comments received, see *Beyond the GAAP* February 2012), the Board has undertaken a long redeliberation process.

The main changes to the initial draft so far are described below.

#### Scope

The definition of an insurance contract falling within the scope of the future standard set out in the exposure draft - which readers will remember was quite close to the definition in IFRS 4 phase 1 - did not attract much comment.

The Board has therefore confirmed this definition, though with some clarifications arising from its redeliberations:

- The standard will apply to investment contracts with a participation feature, but only if these contracts are issued by insurers;
- Financial guarantee contracts will be excluded from the scope, unless they were previously regarded as insurance contracts.

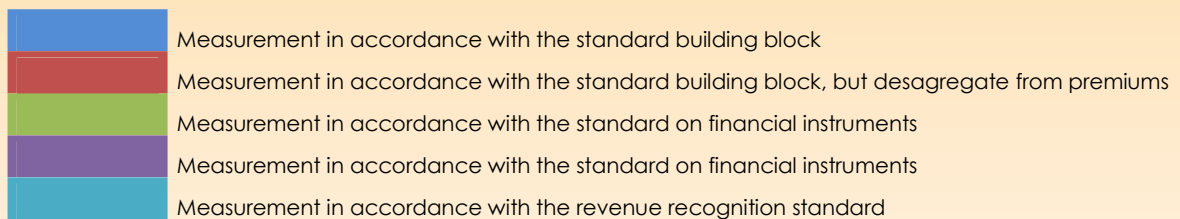
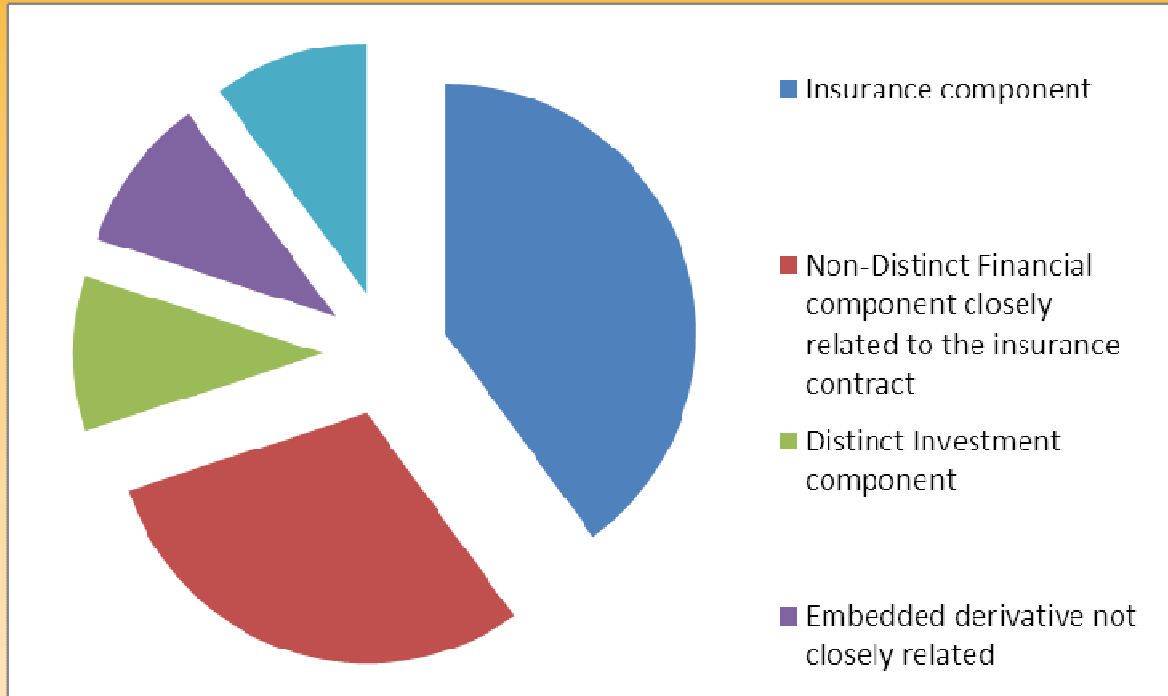
The Board also confirmed that the exclusion criteria for some contracts, such as fixed-fee service contracts, would be the subject of further clarification.

#### Unbundling the components

The Board confirmed the principle of unbundling the components of a contract set out in the exposure draft, including the need to separate embedded derivatives not closely related to the insurance contract.

- Some minor changes to the initial draft have nevertheless been made by the Board. These relate to the necessity of separating distinct goods and services in order to measure them under the Revenue Recognition approach.
- The necessity of disaggregate amounts the insurer must pay to the policyholder regardless of whether an insured event occurs (separate investment component).

The diagram below illustrates the various components of an insurance contract, and the way in which each should be measured.



## Cash flows

Regarding the cash flows to be used when calculating the best estimate<sup>1</sup>, the Board confirmed the stipulation in the exposure draft that all the available information should be taken into account when forecasting future cash flows.

Nonetheless, following its redeliberations, the Board has tentatively decided that it will not be necessary to conduct a full set of simulations for every scenario used when predicting future cash flows.

The Board has also listened to the comments received from insurers regarding the date of recognition of contracts, and has decided that the contract should be recognised at the start of the coverage period (except where the contract is an onerous one), and no longer at the insurer's contract date (when the insurer is bound or first exposed to risk).

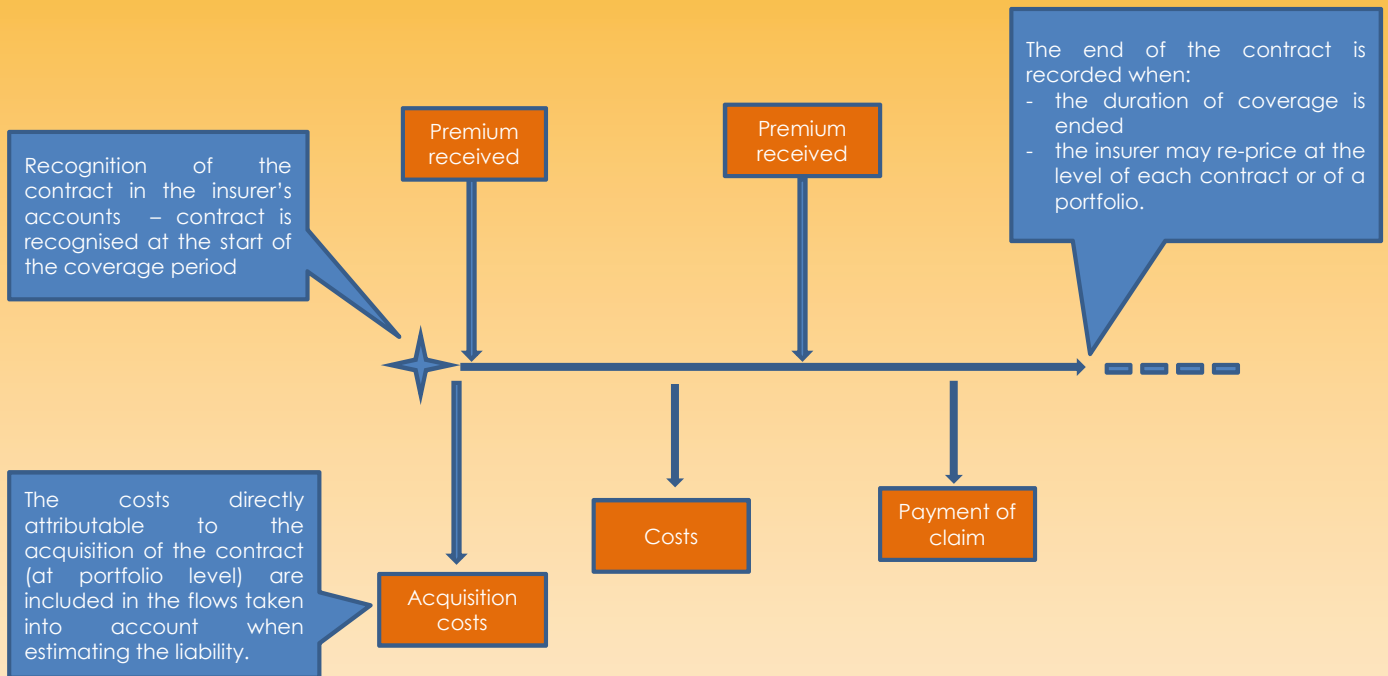
If the shift to this position is confirmed, it would be inconsistent with the position of the most recent Solvency II texts.

For contract acquisition costs, the Board has taken account of the responses of stakeholders and has indicated that these should be calculated at portfolio level, and not contract by contract.

Thus, all the costs directly incurred in concluding the contracts in a portfolio will be taken into account in the cash flows used to estimate the liability. This change, if confirmed, would expand the costs basis to all direct costs (including some direct fixed costs) incurred in acquiring the portfolio.

<sup>1</sup>The "best estimate" of contracts in progress corresponds to a current market-consistent valuation weighted by the probability that future flows from current contract will occur.

The cash flows used in calculating the best estimate are summarised below.



## Discount rate

As we mentioned in the 2012 February Beyond the GAAP edition, many commentators raised criticisms of the exposure draft's discount rate proposals. It will be remembered that the 2010 exposure draft stipulated that:

- the discount rate for the liability cash flows shall be based on the risk-free rate and adjusted to take account of the liability's characteristics, particularly its liquidity;
- the discount rate must be adjusted at the end of each reporting period.

For many commentators, this approach to determining the discount rate induces volatility in profit or loss. In the light of these comments, the Board has therefore reconsidered this subject, and has provided some clarification on the following points:

- **Non-participating contracts:** the general principles remain unchanged. The Board has confirmed that the discount rate should only reflect the characteristics of the insurance liabilities, and should be updated at the end of each reporting period. Having said this, the possibility of recording the impact of updating the discount rate in OCI (Other Comprehensive Income) is still under consideration;
- **Contracts with a participation feature:** the Board has confirmed the necessity of reflecting in the discount rate the link between the yield on the assets and the commitment to policyholders;
- **Method of determining the discount rate:** the Board has indicated that no particular method of calculating the discount rate would be prescribed. Insurers may therefore use any approach which meets the objective. This could be a top-down approach taking account of the expected yield on the assets adjusted for market risk premium, or a bottom-up approach based on the risk-free rate curve to which the insurer would apply a liquidity risk premium which would simply reflect the characteristics of the insurance liability.

## Risk adjustment

For the calculation of the risk margin, the Board has confirmed the positions set out in the exposure draft: an explicit risk margin must be presented, even if determining this risk margin introduces more complexity.

The Board has also revised the objective of determining an explicit risk margin: it represents the compensation for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract, rather than the maximum amount that an insurer would rationally pay in order to be relieved of the risk that ultimate cash flows may exceed the estimated flows.

However, the Board decided to remove the restrictions in the exposure draft on the methods and techniques which insurers may use for this calculation, while retaining the requirement to present the results of the confidence level method in the notes for the purposes of comparison.

The Board is also less prescriptive about taking account of the effects of diversification in calculating the risk margin. It will be recalled that the exposure draft restricted the option of taking into account the effects of diversification to portfolio level. The Board's tentative decisions recommend reflecting diversification to the extent considered by the insurer in assessing the compensation it requires for bearing risk.

## Residual margin

The approach consisting of determining a distinct and explicit residual margin so that no gain is recognised on entering into an insurance contract has been confirmed by the Board. At this stage, the Board continues to uphold the principle described in the exposure draft for the amortisation of the margin over the coverage period.

However, recent discussions have introduced the following elements:

- the possibility of adjusting the residual margin prospectively for changes in estimates of cash flows;
- amortisation must reflect the changing profile of the service provided, in contrast to the exposure draft approach which was based on the passage of time, adjusted where necessary to take account of the timing of cash flows if that pattern differs significantly from the passage of time.

The possibility of adjusting the residual margin to reflect changes to the discount rate has been identified as a point which is still open for discussion within the Board.

Likewise, the Board has still not reached a conclusion on the level to be used for measuring and allocating the residual margin.

**The introduction of the possibility of passing changes in forward estimates on to the residual margin constitutes the main change which has been approved since the publication of the exposure draft.**

## Special applications

At the current stage in discussions, the Board has also taken tentative decisions in the following areas:

- Participation features: The Board has introduced a 'mirroring' approach, which mainly consists of reflecting the interdependence of the underlying assets and liabilities when identifying the discount rate to be applied (a position already existing in the exposure draft) to cash flows and the changes in estimates.
- Reinsurance assets:
  - the Board has confirmed that the same estimates must be used for determining reinsurance assets as for the underlying insurance liability.
  - Losses are recognised immediately if for past events, otherwise recognised over contract term.
  - The Board proposes that in future gains at inception should be recognised over the contract term, rather than immediately.



➤ Simplified approach for short-duration contracts:

- This approach would no longer be mandatory but permitted;
- The Board has extended the scope of contracts which may benefit from a simplified approach to include contracts for which this is a reasonable approximation of the building block approach;
- The Board has also relaxed some requirements in the evaluation of the liability:
  - discounting would only be necessary if it had a material impact (no discounting required when period for satisfying obligations is shorter than 12 months);
  - the onerous contracts test will only be conducted if the facts and circumstances indicate contract might be onerous.

## Presentation and disclosures

The profit and loss accounts as discussed in these tentative decisions should present disclosures on the volumes of premiums, claims paid, and changes in the level of technical provisions. The position of the exposure draft, which was that only changes affecting different blocks of the liability should be presented, no longer appears to apply.

In terms of disclosures, the Board has removed the limit introduced by the exposure draft on the aggregation levels permitted. The exposure draft made reference to operating segments.

Regarding the uncertainty analyses included in the evaluation of liabilities, the Board has made a link between the comments received on the 2010 exposure draft and those which were made with respect to IFRS 13 - *Fair Value Measurement* in terms of the analyses to be conducted on unobservable inputs. The Board has also come out in favour of an alignment of the requirements with those set out in IFRS 13.

The Board has listened to the comments it received regarding the requirement to provide disclosures on the liability maturity analysis, and has decided to limit the analysis to expected maturities. It has also removed the reference to 'contractual' maturities, a concept which was somewhat confusing for some types of contract.

## ➤ The main subjects still under discussion and what is at stake

The main principles for the measurement of liabilities now seem to have stabilised:

- All cash flows expected during the performance of the contract are taken into account, adjusted as necessary for contractual interactions with the underlying assets;
- Discounting of flows using a rate reflecting the characteristics of the liability;
- Use of current and market estimates and assumptions, where possible;
- No gain recognised at inception, and option to adjust the residual margin to take account of changing cash flow estimates (we are still awaiting the details of this 'unlocking').

Nonetheless, some aspects of consistency between the recognition of assets and liabilities, such as the possibilities for using OCI, remain to be discussed. The objective of this part of the study is to summarise the main significant topics which have yet to be tackled by the Board, of which are still under discussion.

## Unbundling contracts

The existing criteria for unbundling contract components do not seem sufficiently clear. Apart from the need to clarify these, the Board should also address the subject of unbundling 'deposit' components, and the presentation of these components.

## Residual margin and Other Comprehensive Income

Although the principles for determining the residual margin at inception seem to have been finalised, the treatment of the margin over the life of the contract remains a thorny question. The main issue at stake relates to the scope for changes in the measurement of the liability to be absorbed in the residual margin.

In conjunction with the previous point, and the many comments received after publication of the exposure draft, the use of OCI (Other Comprehensive Income) to record changes in the insurance liability is still under study.

## Other aspects under discussion

The exposure draft defines the date on which the contract is recognised at the start of the coverage period. The treatment of acquisition costs during the pre-coverage period remains to be specified.

In the case of risk adjustment, the Board has still not ruled on the necessity of including the risk margin in the test of the profitability of contracts. Nor has it stated how frequently the provision for risk should be recalculated. The question of taking into account the effect of diversification must also be studied.

The Board must also consider the outstanding aspects of the onerous contracts test. These aspects mainly relate to the aggregation to be applied when conducting the test, the place of the risk margin in the test, and the frequency with which the test should be carried out. Further, the Board must also discuss how this test is to be applied in the pre-coverage period.

In terms of presentation and disclosures, some areas remain open:

- The Board has still not tackled the question of the separate presentation of short-duration contracts;
- The Board has still not tackled the question of the presentation of reinsurance assets and participation features;
- The Board has not addressed the aggregation level to be applied in profit or loss, by comparison with disclosures which will be provided in the notes;
- The Board has reached no conclusion on how deposits should be separated from premiums.

Finally, transitional arrangements and the date of first application are subjects to which the Board has not yet returned at this stage.

## ➤ Update on convergence with the FASB project

The main joint decisions which ensure consistency between the two draft standards are as follows:

- Measurement of insurance liabilities on the basis of a fulfilment value;
- Measurement and presentation of contracts with a participation feature consistently with the underlying assets;
- Discounting of future flows with a rate reflecting the characteristics of the liability;
- No gains taken at inception;
- Presentation of main profitability indicators.

However, convergence has not been achieved in all areas. The principal differences which remain at this stage are summarised in the table below:

Topic	IASB view	FASB view
<b>Risk adjustment</b>	The risk is explicitly determined and remeasured at each period through P&L	The risk is included implicitly in the single margin and is not remeasured over the contract term
<b>Residual/single margin</b>	<ul style="list-style-type: none"> <li>- Released over the coverage period based on pattern of service.</li> <li>- Some changes in estimates offset in the measurement of the residual margin.</li> </ul>	All changes in estimates recognised in P&L (or OCI)
<b>Acquisition costs</b>	Residual margin shows expected profit after deducting all costs that are necessarily incurred in acquiring and fulfilling the insurance contract liability	Residual margin shows the expected profit after deducting all costs that are necessarily incurred in acquiring and fulfilling the insurance contract liability except those costs that are deemed to not have resulted in issued contracts

The Board's tentative decision to **allow** a simplified approach for short-duration contracts rather than **imposing** it has opened up a new area of divergence with the FASB.

Apart from the areas of convergence proper to the insurance contracts project and set out above, the two Boards also need to discuss the convergence of their respective models for the classification and measurement of financial instruments. The IASB and the FASB have already agreed to work together on this point (see Beyond the GAAP, January 2012).. It will only be in the light of this parallel work, and of any amendments to IFRS 9 and US GAAP which result from it, that we will be able to judge whether the objective of convergence has been achieved.

## ➔ Conclusion

The IASB has confirmed the majority of the principles and proposals set out in its exposure draft of July 2010 (definition of contracts, measurement of liabilities on a liquidation value basis, building blocks, etc.), but it has also listened to a number of the comments which were made in response to the ED.

The principal points which now concern insurers are the introduction of OCI to record changes in insurance liabilities, and the possibility of using the residual margin as a shock absorber. These questions are currently being analysed by the Board, but no decisions have yet been reached. An approach combining assets at fair value in OCI and changes in estimated liabilities also recorded in OCI appears to be the preferred route for the majority of insurers.

A whole raft of topics are thus still pending, and the aim of convergence with the FASB's draft standard (in particular the breakdown of liabilities into three blocks compared with the FASB's two, the treatment of acquisition costs, the absence of a simplified model, etc.) has so far only been partially achieved. Discussions in the forthcoming months will be monitored closely, given their relatively structuring nature. A long and uncertain road lies ahead before publication of the new standard on Insurance Contracts, as is shown by the Board's reluctance to announce how it proposes to proceed with this project. At this stage, the Board has still not decided whether to revise the 2010 exposure draft (a Review Draft) or to publish a new version.

## IFRS

- Application of IFRS 11, *Joint Arrangements*: how should we interpret "other facts and circumstances" in the case of a separate vehicle?
- What are the consequences of the classification of an investment accounted for using the equity method as "held for sale"?
- Acquisition costs of shares in an equity-accounted entity: should deferred tax liabilities be recognised?

## Upcoming meetings of the IASB, IFRS Interpretations Committee and EFRAG

### IASB

16 - 20 April 2012  
21 - 25 May 2012  
11 - 15 June 2012

### Committee

15 - 16 May 2012  
10 - 11 July 2012  
18 and 19 September 2012

### EFRAG

9 - 11 May 2012  
20 - 22 June 2012  
23 - 25 July 2012

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