# IFRS/HKFRS news

In this IFRS/HKFRS news, we update you on the impact of the new insurance standard and IFRS 9 Myth Busters. We share with you update from Cannon Street on changes in policy & estimate, long- term interests, FICE and conceptual framework. Leases lab introduces additional volatility in profit or loss for lessees from lease contracts denominated in a foreign currency.  NIFRICS by numbers for this month talks about practical implications of IFRIC rejections related to IAS 24 "Related-party disclosures".

*In this issue:*



## IFRS 4 Phase II – an opportunity to shine a light on value creation in the insurance industry

***The insurance industry's long wait for a comprehensive standard for insurance contracts is nearly over. IFRS 17 has been a long time in development but is expected in late 2016 or early 2017. This article outline some of the key implications for the industry.***

The financial statements of insurers, and consequently the insurers themselves, have often suffered from unpopularity with many investors because:

- Insurance companies' financial statements are so complex they seem impenetrable to all but deep specialists;
- Measures of performance are difficult to compare.

The complexity of insurers' accounts reflects the fact that insurance is a complex business. The accounts of an insurer tell the story of the intricate relationship between assets and liabilities and the reality that earnings is not a straightforward concept in a business where the profits or losses can emerge over many years in an uncertain pattern. But investors' concerns also focus on lack of comparability between insurers.

Comparability is not helped by the lack of a consistently applied global accounting standard. An array of inconsistent accounting approaches exists under the current standard for insurance contracts ("IFRS 4") contributing to confusion among users and the unfortunate unpopularity of insurance as an investment sector.

The IASB is aware of the lack of comparability and has been working on the development of a new standard for insurance contracts for a number of years. IFRS 17 is close to finalisation and will be published on March 2017. The IASB has promised the industry at least three years to prepare for the implementation with an expected go-live date of 2020 or 2021. IFRS 17 is expected to have wide-ranging application issues and a significant impact across the global insurance industry.

The impact will be global although not universal. Local adoption of IFRS 17 may take some time to confirm (for example European endorsement). The FASB, has already decided to make their own updates to US-GAAP for insurers rather than converge with IFRS. This is likely to add complexity to the financial reporting of multi-national US-headquartered insurance groups — and the story for investors. Subsidiaries may have to report under IFRS for local financial statements, while the group will report consolidated results under US-GAAP.

### *What are the key changes?*

There are three central ideas underpinning reporting under the IASB's new IFRS for insurance contracts:

1. Insurers should report earnings that reflect the services being provided, rather than the cash received;
2. Estimates of future cash flows should be based on current assumptions rather than historic "locked-in" assumptions; and
3. Measurement includes an allowance for risk and uncertainty.

### *Operational impact?*

From an operational perspective, the mechanisms required to calculate and present liabilities and earnings under the new standard will result in complex modelling and data challenges to most insurers, specifically:

- Current estimates of liabilities, including allowance for risks, such as economic risks from embedded options and unchangeable insurance risks;
- A "contractual service margin" to control the release of profits in line with services; and
- The new classification and measurement rules for the new financial instruments standard, IFRS 9.

IFRS 17 will be applied retrospectively for all contracts that are in-force at the date of transition. This will create significant challenges for many insurers when estimating the effect of historic assumptions to establish the opening balance sheet.

The volume of data that needs to be tracked and stored will increase significantly compared to today. Implementation costs could be significant for some. As ever, there will be a trade-off between cost and accuracy, but even analysing the choices and understanding their impact will not be straightforward for many.

### *Will IFRS 17 help investors?*

Improved comparability is likely to be welcomed, but there is no doubt that the new standard is still going to result in complex financial statements that are very different from most current IFRS reporting. For many insurers it will mean fundamental changes in the way liabilities are calculated and a new way of presenting earnings. It will take some time for investors to become familiar with the new earnings story. Complexity will continue to be an issue but that may be a necessary price for the comparability that investors and analysts are longing for.

# IFRS 9 – Myth Buster

***Sandra Thompson, Global IFRS Leader for Financial Instruments busts some of the myths of the new impairment model in IFRS 9.***

IFRS 9, the new financial instruments standard, is well recognised as being a big change in accounting by banks. This is largely due to IFRS 9's requirements in the area of loan loss impairment and the introduction of the expected loss model. The new rules will generally result in earlier recognition of losses compared to today's incurred loss model.

There are a number of common misconceptions over the expected loss model. The following table busts some of the more significant myths!

| | Myth | Fact |
|---|---|---|
| **Relative or absolute?** | Moving from stage 1 (12 month expected loss) to stage 2 (lifetime expected loss) is an absolute test – so that all loans below a specified threshold will be in stage 2. | Moving from stage 1 to stage 2 is triggered by a significant increase in credit risk since the loans were first recognised. Whilst IFRS 9 has a couple of practical expedients, this is in the main a relative test — that will depend on which credit grade a loan started. So two similar loans with the same credit risk at the reporting date but that were originated at different times when they had different credit risks may be in different stages. |
| **How many forward looking scenarios?** | When incorporating forward looking information into impairment provisions it is usually acceptable to use a single "best estimate" of the future (sometimes called a "base case"). | For many loans, credit risk and credit losses are "non-linear", that is, the extra losses in a downside scenario are greater than the reduced losses in an equivalent upside scenario. If this is the case, more than one scenario will generally need to be considered to capture this non-linearity. |
| **Credit cards** | Credit cards are short term so applying IFRS 9 will be straightforward. | Credit cards are giving rise to some of the trickiest application issues, in particular determining the origination date of a credit card and the remaining "life" for IFRS 9 purposes (that is, the period of credit risk exposure). Approaches are still being debated but the effect can be large. |
| **Disclosures** | Banks can leave disclosures to the end of their implementation project. | Banks will need to think about disclosures, including sensitivity analysis, when building IFRS 9 models and systems to ensure they have the necessary information — it may be very hard to go back and generate it later. |
| **Data** | Many banks already have all the information they need. This myth is based on a belief that a bank can use the data it has for regulatory capital with a just a few minor adjustments. | Even banks already applying the most sophisticated regulatory capital approaches will likely need to make a number of adjustments, many of which will require more data and new models. Also, obtaining data on the credit risk of a loan at the date the loan was first recognised (that will be needed to assess whether there has been a significant increase in credit risk) may be challenging when that date was many years ago. |
| **Time left** | There is plenty of time to implement the standard given IFRS 9 only has to be adopted in 2018. | There is a lot to do to analyse and understand the standard, collect data and build models (with appropriate governance). There are also increasing demands for banks to give an estimate of the impact of adoption IFRS 9 well ahead of adoption in 2018. As a result, time is looking very short. |
| **The rest of IFRS 9** | Virtually all of the work needed is on impairment as most of the other requirements are similar to IAS 39. | There are changes to classification and measurement too, which may require detailed work to implement. However, entities can elect not to adopt IFRS 9's requirements for hedge accounting (but instead stay on IAS 39). |

# Cannon Street Press

## *Change in accounting policy and accounting estimates*

The IASB discussed possible amendments to the upcoming ED. The threshold for changes in estimation and valuation technique was removed. This was originally inserted in the draft amendments in April 2016. The ED will also clarify that a change in cost formula of interchangeable inventories is a change in accounting policy. Additionally, there was a tentative decision to require prospective application.

The ED is due out in Q1 2017.

## *Draft Interpretation on long-term interests in an associate or joint venture*

The IASB rejected the draft IFRIC on whether to apply IFRS 9 or IAS 28 to a long-term interest in an associate or joint venture. The Board agreed with the technical conclusions proposed by the IC but expressed concern that the draft interpretation addressed additional issues relating to equity instruments, which were not part of the original request. The Board instructed the staff to explore a more effective way to clarify which standard applies to long-term interests in an associate or joint venture.

## *Financial Instruments with Characteristics of Equity (FICE)*

The IASB continued to discuss the FICE research project.

The Board tentatively decided that the separate presentation requirements should apply to total income and expenses from derivatives on own equity if they meet particular criteria. These requirements will be limited to derivatives with foreign currency exposure and only under certain circumstances. All income and expenses arising from financial instruments that meet the separate presentation requirements should be presented in other comprehensive income.

The Board tentatively agreed to include disclosures on:

- The priority of claims on liquidation;
- The potential dilution of ordinary shares;
- Additional supporting information about the presentation and classification of the gamma approach.

## *Conceptual Framework:*

### *The reporting entity*

The Board tentatively decided that:

- A reporting entity is an entity that chooses or is required to prepare general purpose financial statements;
- The notion of direct and indirect control will be included without the use of the specific terms;
- The proposed concepts relating to the usefulness of information provided in consolidated and unconsolidated financial statements will be included (although the descriptions of the concepts are to be improved).

The Board directed the staff to clarify how the concepts apply to a reporting entity that is not a legal entity.

### *Presentation and disclosure*

The Board tentatively decided to:

- Confirm that the objective of the financial statements is to provide useful information for users in assessing the prospects of future net cash inflows to the entity and managements stewardship of the entity’s resources;
- Describe the objectives of the financial statements as a whole rather than of the financial statement components;
- Identify no primary financial statements and refrain from mentioning their interrelation with the notes;
- Not refer to the statement of cash flows or statement of changes in equity;
- Make no distinction between the terms present and disclose.

### *Asymmetry in treating gains and losses*

The Board tentatively decided that in some cases income may be treated differently from expenses and assets differently from liabilities. The staff will propose wording at a future meeting.

# The leases lab

***IFRS 16 gives rise to a multitude of intriguing questions inspiring Professor Lee Singh to start a new experiment.***

### *Hypothesis*

Lease contracts denominated in a foreign currency under IFRS 16 will create a lot of additional volatility in profit or loss for lessees.

### *Testing and analysis*

Lease contracts might be denominated in a currency which is different from the functional currency of the lessee (for example, contracts might be denominated in USD and the functional currency is EUR). A lease liability has to be translated into the functional currency of the lessee at every reporting date using the closing rate. Any exchange differences are recognised in profit or loss which can impact a company's KPIs. The airline and shipping industries, amongst others, are likely to be affected.

Can volatility in profit or loss be avoided? Let's experiment further!

An entity can designate the lease liability as a hedged item in a hedge of foreign exchange risk. The retranslation of the lease liability is compensated by opposite changes in the fair value of the hedging instrument (typically a FX forward). This approach can be challenging because of differences in the timing of lease payments and cash flows under the forward contract(s). Furthermore, FX forwards with a long term maturity may often only be available at high cost.

The lease liability could be designated as a hedging instrument in a hedge of highly probable future USD revenues (cash flow hedge). Changes in the value of the lease liability due to changes in foreign exchange rates would be recognised in other comprehensive income (OCI) until the USD revenue occurs (to the extent the hedge is effective). However, this approach only works if:

- The entity has sufficient future USD revenues that are highly probable and
- The entity is able to identify and document the time period(s) during which the revenue is expected to occur within a reasonably specific and generally narrow range of time from a most probable date.

A different approach is to use a subsidiary with a USD functional currency (that is, a foreign operation) to enter the USD lease contracts on behalf of the group. The foreign operation as a whole is translated into EUR. Exchange differences that result from the translation of a foreign operation into the presentation currency of the reporting entity are recognised in OCI. Changes in the USD/EUR exchange rate would affect equity but not profit or loss. This approach only works if the functional currency of the subsidiary is genuinely USD. A subsidiary that is only a structured entity set up to enter into lease contracts with third parties and sub-lease the leased assets to other group entities is unlikely to have a different functional currency than its immediate parent. The primary indicators of IAS 21 do not apply to structured entities that have no operations and do not provide any services, but only carry out activities as an extension of the reporting entity without any significant degree of autonomy. Instead, those entities must have the same functional currency as the reporting entity.

### *Conclusion*

Lease contracts denominated in a currency different from the lessee's functional currency could result in more volatility in profit or loss. There are some ways to mitigate this effect.

### *Practical application*

Lessees should analyse how they deal with the additional volatility in profit or loss triggered by lease contracts denominated in a foreign currency. There are several solutions available, however, each has its challenges and a company should assess carefully which approach fits its particular needs.

# IFRIC Rejections in short – IAS 24

***Looking for an answer? Maybe it has already been addressed by the experts.***

The Interpretations Committee (IC) regularly considers anywhere up to 20 issues at its periodic meetings. A very small percentage of the issues discussed result in an interpretation. Many issues are rejected; some go on to become an improvement or a narrow scope amendment. The issues that are not taken on to the agenda end up as "IFRIC rejections", known in the accounting trade as "not an IFRIC" or NIFRICs. The NIFRICs are codified (since 2002) and included in the "green book" of standards published by the IASB although they technically have no standing in the authoritative literature. This series covers what you need to know about issues that have been "rejected" by the IC. We go standard by standard and continue with IAS 24 as per below.

IAS 24 *Related party disclosures* is a disclosure standard. It sets out how related party relationships, transactions and balances, including commitments, should be identified and what disclosures should be made, and when.

Over the years, the IC rejected four issues related to this standard. We will focus on the rejection of May 2015 about the definition of close members of a person's family.

### *Issue*

The definition of close members of a person's family does not specify that the person's parents should be included in this definition. The IC was asked to amend the guidance to specify that the definition include close members of the family according to the law or the prevailing customary norms in the jurisdiction where the entity operates; and to remove the examples of "close members of the family of a person" from the definition.

### *IC considerations*

The IC observed that the definition of close members of the family of a person is expressed in a principle-based manner to determine whether members of the family of a person are related parties or not. Judgement is required to determine whether members of a person's family are related parties or not.

The list of family members is non-exhaustive and does not preclude other family members from being considered as close members of the family of a person.

Consequently, the IC thought that other family members, including parents or grandparents, could qualify as close members of the family, depending on the assessment of specific facts and circumstances. In the light of existing requirements, the IC determined that neither an interpretation nor an amendment to a standard was necessary and therefore decided not to add this issue to its agenda.

### *Summary of IAS 24 rejections*

| Topic | Summary |
|---|---|
| Identifying and disclosing related party transactions by state-owned business entities (May 2004) | The issue was about the practical difficulty for state-owned business entities to identify and disclose related party transactions. The IC noted that this issue was about detailed application of the standard rather than principle. Therefore, the IC declined to add the topic to its agenda. This issue was picked up in the 2007 ED, which resulted in reduced disclosure for government related entities. |
| Disclosure of emoluments to key management personnel (September 2004) | The IC was asked whether it can be inferred from the introduction to IAS 24 (2003) that IAS 24 (1994) did not require disclosure of compensation to key management personnel. The IC noted that this is not the case, and that an entity is required to disclose key management personnel compensation, if the definition of a related party is met under IAS 24 (1994). No interpretation was considered necessary. |
| Interpretation of the term "information" (September 2004) | The IC was requested to supplement the minimum disclosure requirements related to transactions and outstanding balances necessary for an understanding of the potential effect of (related party) relationships on the financial statements. The IC decided not to add this issue to its agenda, as the issue was already considered in the revisions to IAS 24 (2003) and the suggested items were not included. In 2009, the IASB clarified the disclosure requirements in this context (see paragraph 18). |
| Definition of close members of the family of a person (May 2015) | The submitter requested the IC to amend the definition of close members of the family of a person as it does not specify that the parents of a person could be included in this definition. The IC noted that this definition is expressed in a principle-based manner, and that it involves judgement to determine whether members of the person's family are related parties or not. |

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