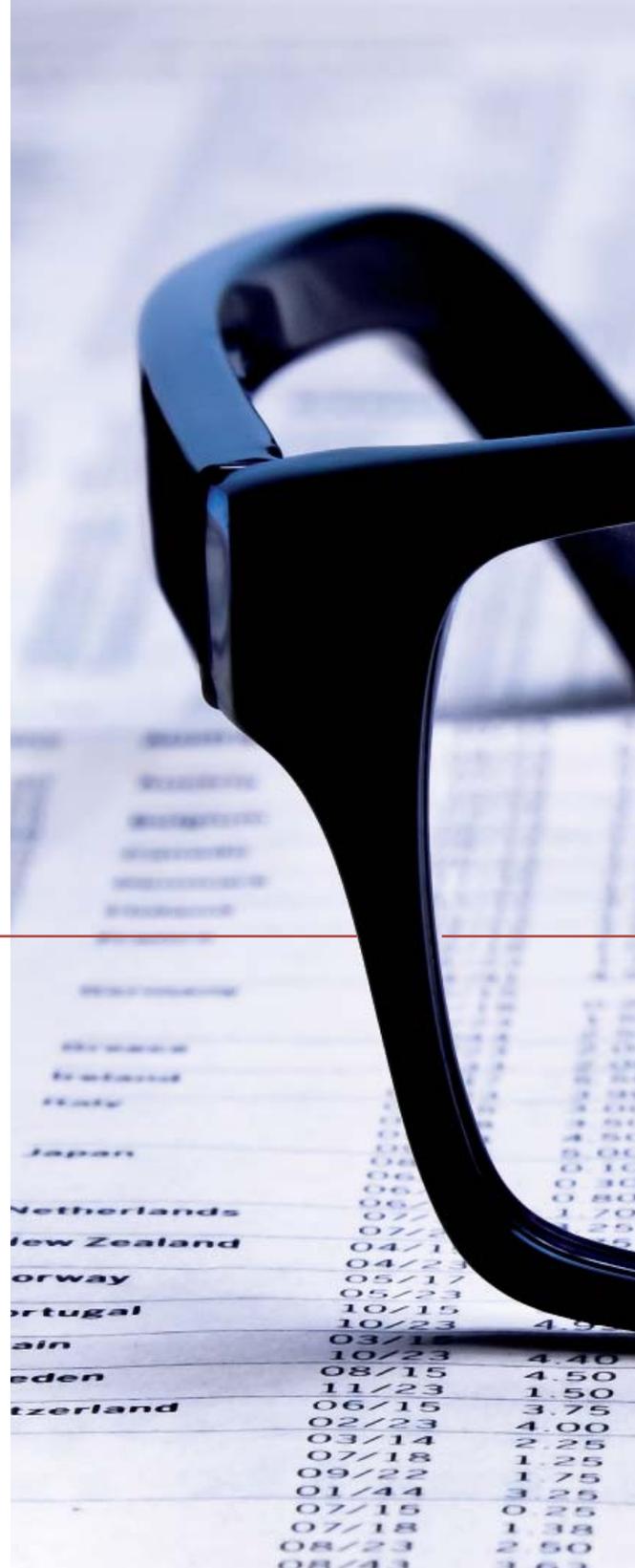


The new IFRS 9 Financial Instruments and IFRS 4 Insurance Contracts Standards

Pedro López
Deputy General Manager
Management Control - Controller
MAPFRE S.A.
Madrid - Spain



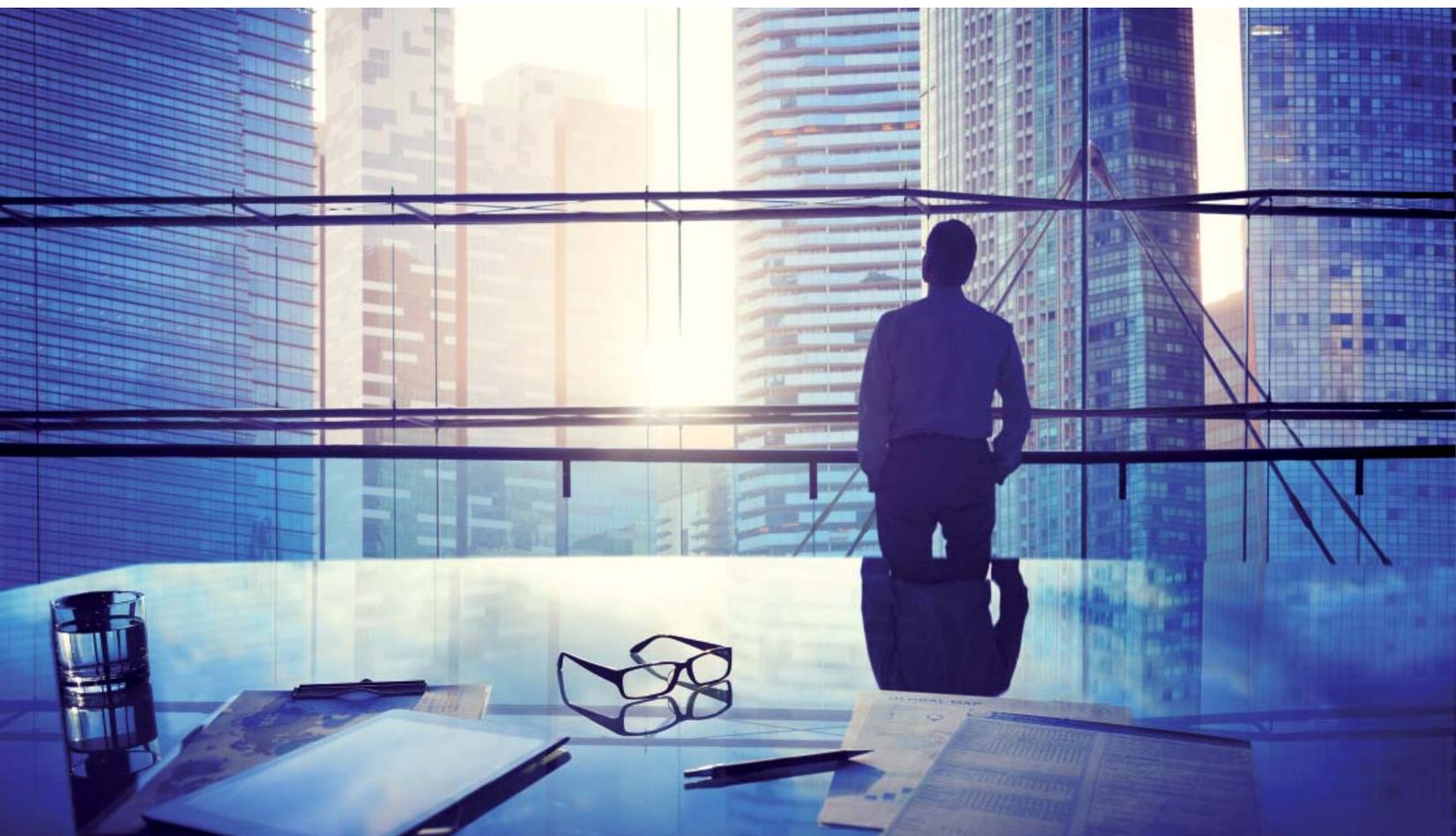
The International Financial Reporting Standards issued by the International Accounting Standard Board (IASB) were adopted by the EU following a ratification process in which the European Commission was advised by the European Financial Reporting Advisory Group (EFRAG) and the Accounting Regulatory Committee (ARC). First implemented in the financial year 2005, IFRSs are now mandatory for all companies listed on EU stock exchanges.



Though not mandatory for other companies, a large number of countries have amended their accounting systems to bring them into line with the IFRSs and spare companies the burden of applying several different schemes. For instance, a holding company listed on the stock exchange is required to receive its subsidiaries' financial statements under IFRS specifications. But if those subsidiaries are not listed, then they are subject to a

different accounting system, which doubles the effort and adds complexity. This is what a large majority of countries, including Spain, can now avoid after adapting their accounting systems.

IFRSs have also undergone a process of convergence with US accounting standards issued by the Financial Accounting Standards Board. As a result, the US Securities and



The EU's original goal was to make company accounts comparable and equivalent within the EU by applying the same accounting criteria for recognition, measurement and reporting

Exchange Commission (SEC) no longer requires companies that use IFRSs to provide a reconciliation to US accounting standards (GAAP).

The EU's original goal, which stems from the property and financial crash that affected countries in South-East Asia and dot-coms in the late 1990s, was to make company accounts comparable and equivalent within the EU by applying -theoretically- the same accounting criteria for recognition, measurement and reporting.

Yet IFRSs were -and still are- based on principles, not detailed rules. This means there is a certain degree of leeway in their application. Salient items including real estate valuation and classification, goodwill impairment and -one of the subjects covered by this article - financial investment classification and impairment criteria are applied flexibly, with no rule determining whether a share should be deemed impaired or not.

Flexible interpretation has led to numerous problems in comparing the accounts of listed companies, which the financial crisis that began in August 2007 has significantly compounded.

For instance, equities that suffered severe downward adjustments in the stock markets were impaired in some cases but not in others, making it impossible to compare the performances of similar companies.

This was no doubt one of the IFRSs' major weaknesses, which the IASB sought to overcome by introducing IFRS 9 to replace the current IAS 39. Preparation of this new standard began in 2008.

As regards the insurance contracts standard (IFRS 4), due to the numerous problems of practical application it involves, its implementation was postponed until a more thorough version is completed, a new version which is currently being drafted. Still, the entry into force of the IFRSs was attended



The IASB has completed a new financial instruments accounting standard that will become effective on 1 January 2018, although it is yet to be adopted by the EU

by the following decisions in the area of insurance contracts:

- ▶ To eliminate equalisation provisions.
- ▶ To test the sufficiency of technical provisions.

This article aims to provide a very brief overview of the significant changes that will affect the classification and measurement of financial investments and their impairment criteria, as well as the now quite advanced draft of the new insurance contracts standard, IFRS 4.

IFRS 9, the new financial instruments standard

The IASB has completed a new financial instruments accounting standard that will become effective on 1 January 2018,

although it is yet to be adopted by the EU. The new standard will replace IAS 39 currently in force, and may be applied in advance on a voluntary basis.

The IFRS is structured into the following three phases:

- ▶ Phase 1: Classification and measurement of financial assets and liabilities.
- ▶ Phase 2: Impairment of financial assets.
- ▶ Phase 3: Hedge accounting.

This article focuses on phases 1 and 2 only, as they contain the largest number of new features with respect to IAS 39.

The current standard lays down four categories for financial asset classification.

- ▶ Financial assets at fair value (equivalent to market value) through profit or loss.

IFRS 9 establishes an expected credit losses model to replace the current incurred loss model. The current impairment regulations included in IAS 39 have revealed that impairment was recognised once the loss had already been sustained

- ▶ Held-to-maturity investments. Financial assets with a fixed maturity date and fixed or determinable payments, which an entity intends and is able to hold to maturity. Held-to-maturity investments are measured at amortised cost and are unaffected by changes in fair value.
- ▶ Loans and receivables. Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They are measured at amortised cost.
- ▶ Available-for-sale financial assets. These are assets that cannot be classified in either of the previous two categories. They are measured at fair value with fair value changes being recognised directly in equity rather than in profit or loss, except where such changes are due to significant and prolonged impairment (decline in the price of the asset). This is the category that gave rise to serious problems in relation to measurement and impairment during the recent financial crisis, as mentioned above.

The above categories established by IAS 39 will disappear under IFRS 9, which is expected to provide a new classification based on:

- ▶ The entity's business model for financial asset management, and
- ▶ The contractual cash flow characteristics of the financial assets.

According to these criteria, financial assets are classified into the following categories:

- ▶ **Financial assets at amortised cost.** These are equivalent to the previous category of held-to-maturity and loans and receivables. The following conditions must be met:
 - a. The asset is managed under a business model whereby financial assets are held in order to collect contractual cash flows (principal and interest); and
 - b. The asset's contractual cash flow solely

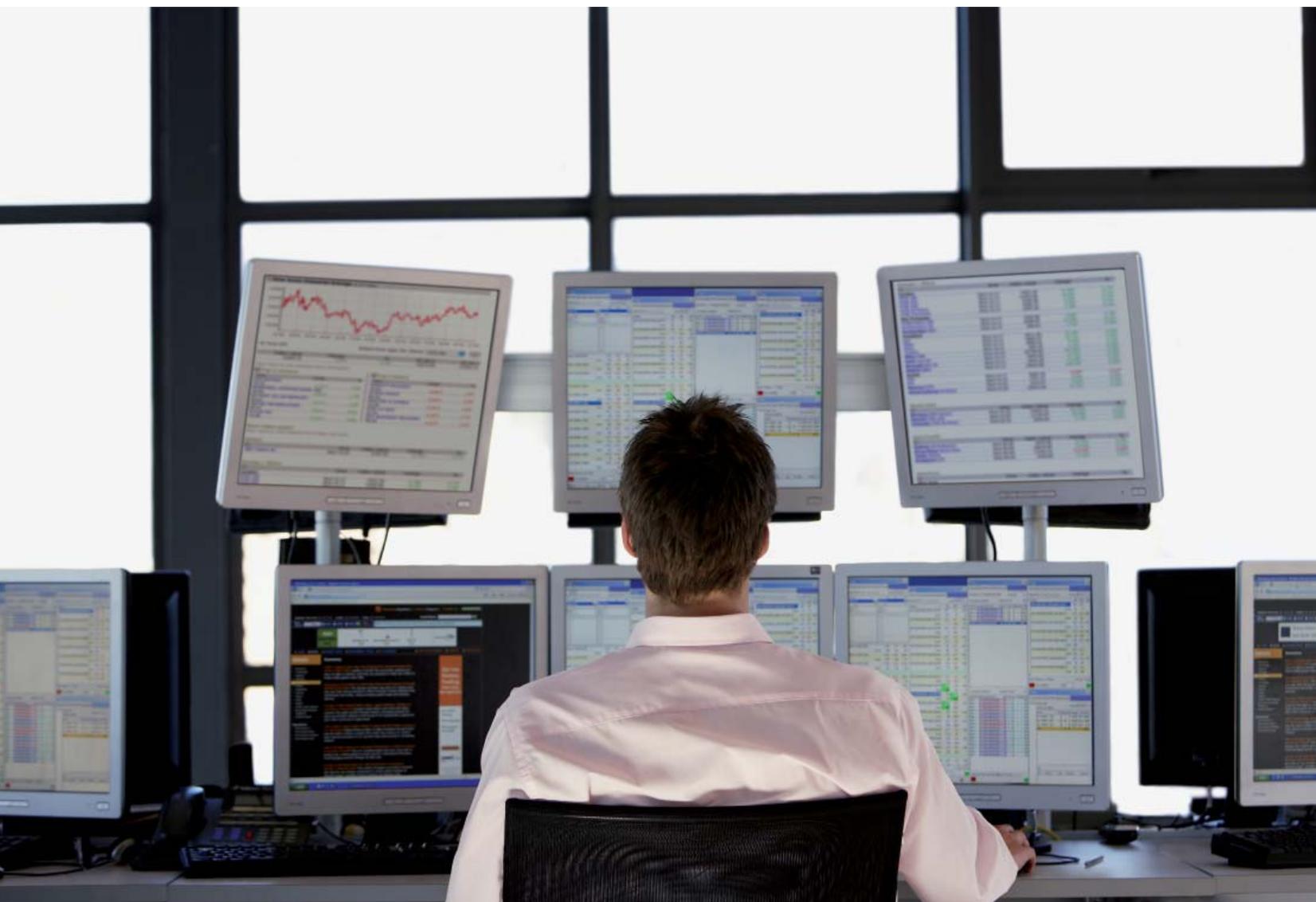
generates payments of principal and interest on specified dates.

This would initially be the appropriate category for fixed income securities. However, an investment bank holding a bonds portfolio for trading would not be able to classify those bonds in this category. The business model needs to be tested to establish whether it involves maintaining the assets throughout most of their life to maturity, in which case they should be measured at amortised cost, or selling them significantly ahead of maturity, in which case the most appropriate measurement method would be fair value through profit or loss, as explained below.

- ▶ **Financial assets at fair value through Equity.** These are measured at fair value with changes being recognised directly in Equity. This category includes assets that meet both of the following conditions:

- a. The asset is managed under a business model the objective of which is to collect contractual cash flows (principal and interest) or cash through asset sale; and
- b. The asset's contractual cash flow solely generates payments of principal and interest on specified dates.

- ▶ **Financial assets at fair value through Profit or Loss.** This category includes all other assets, chiefly equity instruments. It is equivalent to the previous «trading portfolio» category. Assets are measured at fair value, with changes being recognised in profit or loss in all cases. Nonetheless, the entity has the option to decide at initial recognition which equity instruments are not to be included in this category, in which case all value changes are recognised in equity accounts and do not affect profit and loss. In the last two cases, recognition of losses due to impairment is eliminated, as all changes in fair value are recognised in profit or loss or in equity. Thus, there will no longer be any subjectivity in establishing whether an instrument is to be deemed impaired, as was previously the case.



In the area of financial liabilities, IFRS 9 maintains the classification and measurement requirements of IAS 39.

Turning to impairment, IFRS 9 establishes an expected credit losses model to replace the current incurred loss model. The new system has been introduced because the current impairment regulations included in IAS 39 have revealed that impairment was recognised once the loss had already been sustained, whereas the new approach seeks to anticipate potential losses. This impairment model must be applied to all financial assets not measured at fair value through profit or loss (i.e. assets measured at amortised cost, assets measured at fair value through equity, bills of exchange, lending commitments). Equity instruments are excluded.

The new impairment model comprises the following stages:

- ▶ Expected credit losses for the next 12 months must be calculated on every reporting date. The asset's financial revenue is calculated by applying the effective interest rate to its gross carrying amount. This is an expected-loss scenario.
- ▶ If credit risk has significantly increased since initial recognition of the financial asset, the lifetime expected loss for the transaction must be calculated. The asset's financial revenue is calculated by applying the effective interest rate to its gross carrying amount. This is also an expected-loss scenario.



Implementation of the new model may lead to anticipated recognition of credit losses, increased provisions, greater volatility as estimates are lengthened from 12 months to transaction lifetime, and a change in management systems.

The new IFRS 4 insurance contracts standard

The insurance contracts standard is almost certainly the most challenging in terms of practical applicability.

Owing to this great complexity, its implementation was postponed in 2005, when IFRSs became effective in the EU. Indeed, it remains pending approval to this day and, according to the latest reports, it is not envisaged to come into effect before 2018.

Work is currently under way on Exposure Draft 2013, and a final version of the standard is expected to be issued in early 2015.

The scope of IFRS 4 extends to all insurance contracts, whether or not they have been issued by an insurance company, and to Life and Non-Life lines (discussions are ongoing as to whether it will apply to roadside assistance). It applies to direct insurance, accepted reinsurance, and ceded and retroceded reinsurance.

Measurement of insurance contracts according to the standard is based on three key criteria (building block approach):

- ▶ Current value of the cash flows expected for the insurance contract.
- ▶ Risk adjustment; and
- ▶ Contractual service margin.

- ▶ If a loss has already been incurred, the lifetime expected loss of the transaction must be calculated as in the previous stage, but the asset's financial revenue must be calculated by applying the effective interest rate to its amortised cost (the gross carrying amount minus the allocated provision).

1. Current value of cash flows

This is defined as the best estimate of the present value of an insurance contract in its potential scenarios. Thus, it must be unbiased (i.e. determined as the average of a range of possible outcomes) and consistent with current market prices.

It must reflect the perspective of the entity and incorporate, in an unbiased way, all of the available information. For Life insurance contracts, options and guarantees must also be included.

Although the notion of discounted cash flow is common in Life insurance, its application to Non-Life insurance is much more questionable and problematic. There may not be a market for many kinds of insurance, there may be no experience to set a number of scenarios large enough to enable unbiased selection (e.g. disaster classes), and in many markets it may not be possible to establish long-term discount rates (e.g. countries with high inflation).

Applying discounted cash flow is even more problematic where ceded and retroceded reinsurance are concerned, as it will not always be possible to calculate a contract's cash flows based on the direct insurance contracts or the accepted reinsurance contracts they protect. An example of this is a non-proportional ceded reinsurance cover protecting an insurer's net retention money for earthquake insurance.

Lastly, the Exposure Draft provides that the discount rates used in cash flow measurement may change over the term of the contract, as such rates are based on the discount rates prevailing at each accounting time. In this case, changes in the current value of cash flows resulting from changes in the discount rate should be reflected in equity, not in profit or loss.

2. **Risk adjustment** is defined as the amount required by an insurer to offset the uncertainty about the amount and timing of cash flows. Obviously, it is a downward adjustment of cash flow current value, and it is recognised in loss in all cases.

Risk adjustment may be associated with the notion of confidence interval in statistics, i.e. a margin deducted from cash flows in order to secure a reasonable confidence range. For instance, if the current value of expected cash flows is reduced by 5 per cent, it will have a 95 per cent likelihood of being realised.

The risk adjustment must be recalculated at every accounting period, and any differences generated in the current value of cash flows as a result of changes in risk adjustment must be recognised in profit or loss.

3. **Contractual service margin**

Application of the approach described in the preceding points would make it possible to recognise at time 0 the profitability generated by an insurance contract. This could lead to a situation in which a contract's profit would have to be recognised in full on the first day of its term. The contractual service margin averts this clearly unreal situation by reflecting the future profit of effective contracts and deferring recognition over the coverage period. This notion is analogous to an unearned premiums provision.

Future profit, which is recognised as expected gains are realised over time, is recognised as an insurance liability (provision) that diminishes after expected gains are accrued.

Conclusions

It may be gathered from the above description of the new IFRS 4 that insurance contract accounting is set to become much more complicated, as it will take in -particularly in Non-Life classes- items that had so far never been included, such as cash flows, interest rates, margins, confidence intervals, etc. Still, IFRS 4 also simplifies the general model for certain Life products (unit linked) and short-term contracts.

The new standard will require heavy investment in the technology needed to perform these complicated calculations. But the largest investment to transform accounting into a measurement of assets and liabilities will have to be made in training, so that company staff become highly qualified and skilled in actuarial science rather than accounting.

The new standard will require heavy investment in the technology needed to perform these complicated calculations. But the largest investment will have to be made in training, so that company staff become highly qualified and skilled in actuarial science rather than accounting