

RSM Reporting

**Welcome from
the Editor**
Marco Mongiello

Welcome to the tenth edition of RSM Reporting – the newsletter from RSM International covering technical developments in global accounting and reporting.

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Section 3: Top Ten Topics in IFRS

by Joelle Moughanni

We have witnessed an intense level of activity of the IASB and FASB on a number of topics in the last several months as highlighted in the 'accounting and reporting this quarter' section of the last few editions of *RSM Reporting*. The widespread impression among preparers and users has been a mixed feeling that the boards are aiming at keeping pace with the ever changing requirements of the global business environment, but often struggle to keep up with their own agenda. Times are turbulent and require a clear vision from the boards. Later, we address these concerns directly at the top of the IASB talking with its Vice-Chairman, Ian Mackintosh.

Two themes that emerge from the interview are the importance and dissemination of IFRS for SMEs and the consideration on the links between the financial crisis and accounting and reporting. The first is the subject of Gil Rosenstock's and Shlomi Shuv's short series on hierarchy establishing accounting policies in IFRS for SMEs. On the other hand, Timo van Eeden explores the effects of IAS 19 Employee benefits on firms' performance indicators, which are a concern for many stakeholders in periods of crisis.

The Top Ten Topics page touches base on the practical consequences of the lengthy work that the IASB and FASB have been doing on reporting insurance contracts. Joelle Moughanni makes this page the indispensable tool for anyone who ventures into making sense of the IASB's various deliberations and re-deliberations on this matter.

I hope you find this edition an enjoyable and interesting read. As ever, please contact the editorial team with any comments on this and the past editions or suggestions for the next edition.

Dr Marco Mongiello ACA
E: m.mongiello@imperial.ac.uk

1 Accounting and reporting this quarter

IASB

>> for further news and updates please visit www.ifrs.org

IASB

September 2011

The IASB and FASB continued their discussions on insurance contracts with particular reference to the required disclosures, which may need to be aligned with the provisions of IFRS 13 on Fair Value Measurement. The boards seem to find it difficult to reach full consensus.

The IASB and FASB reached an agreement with regards to the technique of transferring financial assets from one category (called 'bucket') to another in the context of impairment. Though not conclusive for the users, very importantly the agreement sets a clear direction in that it requires the 'bucket' technique to be addressed as a matter of principle as opposed to 'bright line'.

The IASB and FASB are still discussing the treatment of leases.

October 2011

The IASB and FASB have reached the unanimous decision of excluding certain types of fixed fee contracts from the remit of insurance contracts. The criteria they have to meet are that (i) contracts' prices do not

reflect an assessment of risk, (ii) the payment to the client is in services rather than cash and (iii) the risk transferred is linked to the frequency of the use of a service. Also some agreement has been reached with regards to the presentation of insurance contracts in the statement of financial position.

The IASB and FASB seem to have reached some conclusions with regards to the presentation of the leases for the lessor, though most aspects of leasing are still under discussion.

November 2011

The IASB and FASB issued for public comment a revised draft standard to improve and converge the financial reporting requirements of International Financial Reporting Standards (IFRS) and US General Accepted Accounting Principles (GAAP) for revenue (and some related costs) from contracts with customers. The comment period of the exposure draft closes on 13 March 2012.

EFRAG

>> for further news and updates please visit www.efrag.org

EFRAG

September 2011

EFRAG started several consultations on draft comment letters but did not publish any final comment letter.

October 2011

EFRAG has formally endorsed the IASB's Amendments to IAS 19 Employee Benefits. The amendments focus on the immediate recognition of all changes in the net liability or asset (elimination of the 'corridor approach' and elimination of options in the presentation of actuarial gains and losses), the disaggregation and presentation of defined benefit cost components, redefining the components of defined benefit cost, the treatment of plan amendments, curtailments and settlements, termination benefits and improvements in disclosures.

EFRAG has formally endorsed the IASB's Amendments to IAS 1 Presentation of Items of Other Comprehensive Income. The amendments require separate presentation of items of other comprehensive income that are reclassified subsequently to profit or loss (recyclable) and those that are not reclassified to profit or loss (non-recyclable). If items of other comprehensive income are presented before tax, then income tax is allocated to each respective group.

November 2011

EFRAG welcomes the Board's decision to postpone the effective date of IFRS 9 Financial Instruments, but considers that the revised effective date of 1 January 2015 provides insufficient relief. EFRAG believes that rather than setting a fixed effective date, it would be more appropriate to allow entities at least three years to implement IFRS 9 from the publication date of either the last phase of IFRS 9 or of the standard on insurance contracts, whichever is the latest.

EFRAG has expressed the comment that it agrees, in principle, that entities adopting IFRS 9 on or after 1 January 2012 should be required to restate comparative information. However, it encourages the IASB to reconsider the transitional requirements of IFRS 9 to ensure that the restated comparative information is meaningful. If the IASB were to conclude that it is not possible to revise the transitional requirements such that the comparative information is meaningful, EFRAG would recommend that relief from restating comparative information be granted.

2 The point of view of ...



Editor's interview

The words attributed to the interviewee represent his own personal opinions and do not represent the official position of the IASB.

In stark contrast with the freezing economic forecasts, it is a sunny and unexpectedly hot afternoon in the early days of this autumn when I met Mr Ian Mackintosh, the Vice-Chairman of the IASB, in his office in London.

I have seen and heard Mr Mackintosh speak at a number of conferences in the past and I know I can expect a frank conversation with him. It is the first time I have talked to him in his new role at the IASB and I am extremely pleased that *RSM Reporting* is given the opportunity to access his insights and personal views and opinions. Mr Mackintosh has previously occupied the position of Chairman of the ASB, the UK accounting standard setter, and, hence he possesses an enviable knowledge about how national standard setters interact with the IASB.

As he played such an important role in the debate on the adoption of the IFRS for SMEs in the UK and the consequent effects on the UK GAAP and FRSSSE, I seize this widely interesting topic for my ice-breaking question.

How do you see the adoption of the IFRS for SMEs happening around the world? The wider public is aware of the various possible choices, from full adoption (for example in South Africa) to their adaptation (for example, in the UK). Do you see a pattern? What should users and preparers expect in the world of reporting in SMEs in the foreseeable future?

As you have noted there have been various possible adoptions of the IFRS for SMEs standard around the world. South Africa, for instance, has fully adopted and the UK has not finally decided as yet, but it looks as though it will adapt rather than adopt the IFRS for SMEs standard. However, a more important fact is that the IFRS for SMEs is being very well received in many countries and in particular in emerging economies. These are economies that do not have the capacity at this stage to take up the full IFRS. In fact, they probably do not have many companies that would require using the full IFRS.

In this context, taking up the IFRS for SMEs is very useful because it is a good first step to getting into the IFRS forum. At IASB we are very pleased about this and we are trying to help these countries, as much as we can, to have a successful adoption of the IFRS for SMEs. However, it is clear at this stage that some countries will not adopt them. For instance, my understanding regarding the EU is that although the EU will not require the adoption of the IFRS for SMEs, it will not ban it either. I am pleased with this fairly neutral stand. In my opinion, no country should be forced to adopt the SMEs standard, particularly when the companies in that country have established existing standards that historically have served them satisfactorily.

I do not think that in the foreseeable future we will reach a stage where the IFRS for SMEs is adopted globally. However, in my opinion, this should not be a matter of concern for the IASB. I think instead that we are in a very promising position at this stage and that the IFRS for SMEs will be used more and more as time goes by.

I venture in potentially more controversial grounds with my next question.

The IASB/FASB convergence was not completed by June 2011 and Sir David Tweedie has now passed the baton to Hans Hoogervorst as the new Chairman of the IASB. Will we see, under the new chairman's leadership, the future of international accounting and reporting less dependent on this convergence? Should we accept as a fact that there is no scope for actually ever completing the memorandum of understanding?

IFRS for SMEs are currently adopted in many jurisdictions and available in the following languages:

Albanian	Armenian	Chinese	Czech
English	French	Italian	Macedonian
Mongolian	Polish	Portugese (Brazi)	Romanian
Russian	Spanish	Turkish	

Translations in process: Estonian, Hebrew, Japanese, Kazakh, Khmer, Ukrainian

Translations under discussion with the IFRS Foundation: Bosnian, Bulgarian

¹ Ian Mackintosh is Vice-Chairman of the IASB and former Chairman of the ASB

Guest Contributor

The previous chairman, Sir David Tweedie, his board and its staff worked very, very hard to attempt to complete the convergence programme by June 2011. Even though that was not achieved, I can absolutely assure you (because I was there for part of the period) that it was not for want of trying, but instead because these things are not easily or quickly resolved. Myself and Hans are continuing to work with the present board on the convergence programme. We are continuing to work on the revenue recognition standard, the leasing standard and the financial instruments standards and we are also working with FASB on the insurance standard, which was not part of the original convergence programme. We are making different levels of progress on each one. We should have an exposure draft soon for revenue recognition and, hopefully, also for leasing. We are working very hard to get to convergence on financial instruments which we recognise is very important for global financial reporting. We are waiting for our American counterpart's decision on whether they are going to adopt, converge or incorporate and we are very hopeful that the decision will be made this year. In fact, as we have not heard anything from them suggests their decision will be delayed. They have promised a decision by the end of the year and this is what should happen. Only upon receiving their decision will we be able to fully work out how to progress in the future.

The US SEC had a very good section in its last staff report, the one that referred to incorporation, on the role of the FASB going forward. Although this is only a staff paper, i.e. not an official position of the American regulator, it is promising for its forthcoming decision. Clearly though, FASB will remain a predominant standard setter in the world. It has excellent resources and it is the standard setter for the world's largest economy so it is, and will continue to be, an important body. That paper suggested that FASB will continue to work with the IASB as a national standard setter, as other national setters work with us, and will have a role of endorsement of IFRS in the US system. But for now we have to wait for their final decision.

This all sounds very promising for the future, however, can it be said that FASB has been trying to have too much influence on IASB, particularly in light of the fact that IFRS have not been fully adopted in the US? We seem, for example, to use more rules than principle-based accounting would be expected to have.

I do not think we can accuse FASB of trying to gain too much influence. The 2002 Norwalk agreement was a clear cut agreement. The range of convergence and the methodology to reach convergence and the respective roles of FASB and IASB were clearly set out and have been followed ever since.

The two boards have been learning from each other and IASB has demonstrated flexibility to set standards slightly differently. I think that the standards that have come out of the convergence project show the use of both boards' contributions. FASB has been working as a partner in the convergence, so, of course its influence is coming through.

How are things going to change under the new leadership? Is IASB/FASB convergence losing momentum in Hans Hoogervorst's agenda?

Sir David Tweedie took on the task of the convergence in 2002 and worked very hard towards it. We are now nearing the completion of that agreement and, naturally, our mind turns to the future. I do not think there is anything more than that. I do not think that Hans is coming out with a different attitude, it is the situation that is different and it is time to think about the future. As I said before, a lot of this hinges on the decision of our American equivalent.

Hans Hoogervorst's background includes advisory positions of IASB and FASB and, prominently, various roles as minister of the Dutch government. Should we expect him to make IASB play a more political role in the global arena during his mandate?

I think that IASB has always had to be involved politically to some degree. Sir David was very competent in dealing with the political matters as well. Obviously he was very competent technically, but in the international world, in the global current context, inevitably you get caught up in political situations. The best example is the G20 and the role it took in guiding both boards and encouraging them to complete the convergence programme and to give one set of global standards. Hence, yes, political influence, but that is reality in time of crisis. I think Hans is coming up to speed very rapidly and his political skills will be very useful in the future.

2 The point of view of ...



Ian Mackintosh

... on Global financial crisis and a change at the top: a crucial time for the IASB

Speaking of G20, you took the job as Vice-Chairman of IASB upon the IASB being called to respond to the G20 in the context of the global financial crisis. Is the launch of IASB's agenda outreach programme a response to this situation? Should we expect a radically different way in how international accounting will develop in the foreseeable future? Perhaps less frequent technical modifications? More political informed choices? A different due process?

We are doing an agenda consultation and this is an undertaking that we will carry out every three years. This was in place when we came on board. In the consultation document we are asking questions on two levels. On a higher level we are hearing from people that they want a period of calm. For the constituencies it has been busy and it will be very busy in the run up to 2015 when the new standards will come in. There is a demand for us to sit back and to look at the concepts. Also, constituencies are worried about complexity and want us to look at the disclosure framework. We are undertaking post-implementation review which we will start in a couple of months with IFRS 8. We want to have some time to do some blue-sky big-picture thinking addressing the question of what financial reporting is about.

We are committed by the trustees to increase our research capacity, which can be by ourselves or with other parties from around the world such as standard setters, academics or business groups.

The agenda consultation is needed for us to understand if this is what constituencies really want us to do. The problem is to evaluate how many projects should be put onto our work plan in the time available.

The second level of questions is about which projects are the most important in the constituencies' eyes. In that document we have 23 suggested projects, but how many do the constituencies want us to have on our agenda and which ones? This is a very important question.

Is this also aimed at ensuring you can set credible deadlines?

We are considering moving projects back to the research phase. We plan to have a longer term research project, which perhaps could end up in a discussion paper. By the time we take the topic onto the work plan we have a good idea of the scope of the topic, what the problems are and how difficult it is going to be to resolve them. We want to have a much clearer idea of what we are up for. This is one path we are looking at to make the situation more efficient.

Also, the due process has continued to evolve. Our due process subcommittee of the trustees is now meeting monthly and the IASB reports to it on the progress of the projects. This is being taken very seriously. This is why in the last few years we have seen more and more outreach, more round tables, more consultations, more one-to-one meetings. That is a good thing, which will continue. We just have to watch that there is not so much due process that we never reach a decision. There is a balance that has to be struck and we have to work out where the balancing point sits. So, we need to also outreach to a lot of groups who have an interest including the European parliament, regulators and user groups to name but a few. We will work hard to keep in touch with all of them.

As you mentioned, the EU is a fundamental interest group. Would IASB be more comfortable if the EU made more adoptions and less adaptations?

The trustees' goal is full adoption. But, realistically, countries or regions will not give up their sovereignty and will always want to have the opportunity to review anything that is eventually becoming law in these countries. So we cannot expect them not to want to review. We would hope that changing or not accepting things is a very rare occurrence and, if you look at the EU, it is indeed a very rare occurrence.

Guest Contributor

...but EFRAG does not seem to be able to ever make a full endorsement. In their letters there is always a 'yes...but'...

EFRAG members always try to balance pros and cons. It is their job. So they cannot be totally positive if they think that there are some weaknesses. The only major carve-outs we had were the three initially on IAS 39 and they have now been reduced to one. Most companies in Europe are not using the carve-outs; the huge majority of the companies are using the full IFRS. Admittedly, we have the non-endorsement of IFRS 9, but that is a delay as the EU itself has said. They haven't said yes or no as yet.

In the global context do you think the EU's attitude could represent a precedent for other constituencies, particularly in emerging economies, who will feel entitled to adapt the IFRS as they please?

I think most countries will look at whether they should adopt standards as they come through. For example, Australia has not rejected any standards, but they still have the ability to reject should they wish to. We think that the push for globalisation of the markets in general will lead to more and more countries not having exceptions. Otherwise their companies will not be reporting in the same way. These countries will certainly have an internal pressure not to accept this or that, but they have got to weigh that up against their place in the global economy. We will see non-adoptions of some parts of the IFRS in some countries and some parts of the world, but gradually less and less of that will occur as the time goes by.

Ian's conclusion is: "So in the long term, I am an optimist", which sounds to me like the perfect note to conclude this interesting conversation with a man who is able to instil positive thinking with a long term view...even if the short term is gloomy.

Guest Contributor: Ian Mackintosh

In 1976, Ian became a Partner of Coopers and Lybrand, and up until 1996 held that position in Sydney, Canberra and Vanuatu.

In 2000, Ian joined the Australian Securities and Investments Commission as its Chief Accountant. In that role he had overview of the financial reporting of the financial markets in Australia. In 2002, he joined the World Bank as Manager, Financial Management, South Asia. This involved working with the governments and communities of South Asia on financial reporting, financial management and governance issues.

Ian was appointed Chairman of the UK Accounting Standards Board in August 2004. He resigned from that position in October 2010 and took up the role of Vice-Chairman of the IASB on 1 July 2011.

Ian has been involved in accounting standard setting for over 20 years. Roles have included Chairmanship of the Australian Public Sector Accounting Standards Board and the IFAC Public Sector Committee and Deputy Chairmanship of the Australian Accounting Standards Board.

Ian is a Fellow of the Institute of Chartered Accountants in Australia, a Fellow of CPA Australia and a Member of the Chartered Institute of Finance and Public Accountancy. He is an Adjunct Professor at the University of Canberra and a Fellow of that university.

2 The point of view of ...



Gil Rosenstock and Shlomi Shuv

... on IFRS for SMEs - Hierarchy to establishing accounting policy (2 of 3)

This is the second article in a series of three on the application of the IFRS for SMEs.

In the first article, we introduced the concept of hierarchy of sources that preparers should use, when faced with lack of explicit directions in the IFRS for SMEs. We have also listed and proposed a solution for three such cases: (i) Transfer of a property to, or from, investment property, (ii) Classification of gains from sale of assets held for rental and (iii) Accounting-policy choice for the recognition of actuarial gains and losses.

In this article, we will further cover the following cases:

- » Offsetting a financial asset and a financial liability in the statement of financial position
- » Quantitative threshold in relation to substantial modification of the terms of a financial liability
- » Date of documenting hedging relationship
- » Exceptions to the recognition and measurement principles used to account for business combinations
- » Classifying and designating assets acquired and liabilities assumed in a business combination

Offsetting a financial asset and a financial liability in the statement of financial position

IAS 32 states that a financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

- (a) currently has a legally enforceable right to set off the recognised amounts; and
- (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

There is no mention in the IFRS for SMEs of the issue of offsetting a financial asset and a financial liability in the statement of financial position. It should be noted that the Concepts and Pervasive Principles of the IFRS for SMEs include an unequivocal instruction, according to which an entity shall not offset assets and liabilities in the statement of financial position unless required or permitted by the IFRS for SMEs.

Based on the hierarchy to establishing accounting policy [see first article of this series in issue 9 September 2011], an entity shall not turn to full IFRS for guidance for offsetting a financial asset and a financial liability. This is because wherever there is a specific guidance

in the Concepts and Pervasive Principles of the IFRS for SMEs, the entity is required to follow the specific guidance, rather than turning to full IFRS, which is lower in the hierarchy.

This would lead to the conclusion that an entity shall not offset a financial asset and a financial liability in the statement of financial position under any circumstances. However, in the authors' view, that conclusion was not the intention of the IFRS for SMEs.

Quantitative threshold in relation to substantial modification of the terms of a financial liability

The principles for the derecognition of a financial liability set out in IAS 39² and in the IFRS for SMEs are basically the same. However, the IFRS for SMEs does not mention a quantitative threshold in relation to substantial modification of the terms of an existing financial liability.

It is worth noting that the application guidance to IAS 39² adopts the ten percent threshold test, whereby the terms are substantially different if the discounted present value of the cash flows under the new terms (including any fees), discounted using the original effective interest rate, is at least ten percent different from the discounted present value of the remaining cash flows of the original financial liability.

Based on the hierarchy to establishing accounting policy, in the absence of a specific quantitative threshold in the IFRS for SMEs, an entity is allowed, but is not required, to turn to full IFRS for adoption of the ten percent threshold test. However, in the authors' view, an entity is allowed to adopt another quantitative threshold and apply it consistently.

Date of documenting hedging relationship

IAS 39² states that a hedging relationship qualifies for hedge accounting if, among other conditions, at the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge. That documentation includes, among other things, identification of the hedging instrument, the hedged item and the nature of the risk being hedged.

Similarly, the IFRS for SMEs states that to qualify for hedge accounting, an entity shall designate and document the hedging relationship so that the risk being hedged, the hedged item and the hedging instrument are clearly identified. However, the IFRS for SMEs does not specify whether the formal designation and documentation shall occur at the inception of the hedge.

² In these instances IFRS 9 will not bring significant changes to the current letter of IAS 39.

Based on the hierarchy to establishing accounting policy, in spite of the absence of a specific date in the IFRS for SMEs for the formal designation and documentation of a hedging relationship, in the authors' view, due to the nature and substance of hedge accounting, an entity is required to apply the same requirement in full IFRS, and designate the hedging relationship at the inception of the hedge to be eligible for hedge accounting.

Exceptions to the recognition and measurement principles used to account for business combinations

IFRS 3 provides for some limited exceptions to the recognition and measurement principles, whereby, as of the acquisition date, the acquirer shall recognise, separately from goodwill, the identifiable assets acquired and the liabilities assumed at their acquisition-date fair values. Those include, among other things, recognising and measuring deferred tax assets or liabilities, liabilities related to the acquiree's employee benefit arrangements, indemnification assets, reacquired rights and replacement of an acquiree's share-based payment awards.

The IFRS for SMEs states that the acquirer in a business combination shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets and liabilities and a provision for contingent liabilities that satisfy the recognition criteria at their fair values at that date. The IFRS for SMEs does not provide any exceptions to the rule of "acquisition-date fair value".

Based on the hierarchy to establishing accounting policy, in the absence of any exceptions in the IFRS for SMEs, an entity shall not turn to full IFRS for recognising and measuring assets or liabilities other than at acquisition-date fair value. SMEs are prohibited from straying from the unequivocal instruction in the IFRS for SMEs, according to which assets and liabilities shall be measured at acquisition-date fair value. The entity is required to follow the specific guidance, rather than turning to full IFRS, which is lower in the hierarchy. However, in the authors' view, that conclusion was not the intention of the IFRS for SMEs.

Classifying and designating assets acquired and liabilities assumed in a business combination

IFRS 3 states that at the acquisition date, the acquirer shall classify or designate the identifiable assets acquired and liabilities assumed on the basis of the contractual terms, economic conditions, its operating or accounting policies and other pertinent conditions as they exist at the acquisition date.

IFRS 3 provides an exception to the principle (the other exception is not relevant to SMEs), according to which an entity shall classify a lease contract as either an operating lease or a finance lease on the basis of the contractual terms and other factors at the inception of the contract, rather than at the acquisition date.

No guidance exists in the IFRS for SMEs regarding the classification or designation of the identifiable assets acquired and liabilities assumed in a business combination. In light of the fact that the acquirer shall recognise the acquiree's identifiable assets and liabilities at the acquisition date, in the authors' view, the entity shall classify or designate them on the basis of the contractual terms and other conditions, as they exist at the acquisition date.

Furthermore, in the absence of both the rule and the exception to the rule regarding a classification of a lease contract as either an operating lease or a finance lease, in the authors' view, an entity shall turn to the guidance in IFRS 3, according to which such a classification shall be made on the basis of the contractual terms and other conditions as they exist at the acquisition date.

It should be noted that classifying leases as either finance leases or operating leases is applicable only under the current version of IAS 17 Leases. However, the Exposure Draft Leases, published in August 2010, proposes that lessees and lessors should apply a right-of-use model in accounting for all leases, without the need to distinguish between finance leases and operating leases. Assuming the Exposure Draft will be finalised, it remains to be seen whether the leasing revolution will find its way to the IFRS for SMEs.

Gil Rosenstock, CPA, IFRS Consultant
Head of Professional Practice in
RSM Shiff, Hazenfratz & Co, Israel

T: +972 (3) 791 9111
E: gil_r@shifazen.co.il

Shlomi Shuv, CPA, IFRS Consultant,
Vice Dean at the School of Business (IDC)
Herzliya, Israel

T: +972 (9) 952 7655
E: shuvs@idc.ac.il

2 The point of view of ...



Timo van Eeden ... on IAS 19 - Employment benefits

International Accounting Standard 19 (IAS 19) on Employee benefits has been heavily debated since its introduction in the European Union in 2005, especially the accounting for post-employment benefits. Common criticism included the following:

- a) Changes in the deferred benefit (DB) pension liabilities are difficult to explain and to understand by both the preparers and the users as no relation to the pension premiums paid is observable
- b) It is deemed expensive for the preparers due to the necessary extensive actuarial calculations
- c) The standard is rigid with respect to the classification of pension schemes as defined benefit or defined contribution (DC). Proper classification is difficult to assess due to the large variety in pension schemes that are initially situated somewhere in between DB and DC
- d) The comparability of reported results is impaired due to the fact that companies have the choice whether or not to defer the recognition of actuarial gains or losses

In March 2008, the IASB issued a discussion paper that included renewed views on the deferred recognition of actuarial gains and losses and on the accounting principles for pension schemes that could be classified as somewhere in the middle between DB and DC plans. The later item especially faced severe opposition, claiming that the proposed accounting policies were overly complex and would not produce consistent results.

In response, the IASB issued a more modest exposure draft in April 2010 which was the basis for the revised version of IAS 19, as published in June 2011, and effective as of the financial year starting on or after 1 January 2013.

IAS 19R is viewed as an intermediate step in the achievement of the ultimate goal to develop an all new accounting framework for post-employment benefits as it does not resolve all the issues noted when applying the current IAS 19. However, the revisions included in IAS 19R will significantly influence the reported results on employee benefits, most importantly on post-employment benefits such as pensions.

The main revisions and the related effects are as follows:

- a) *Re-measurements recognised in other comprehensive income (OCI) immediately*

Actuarial gains and losses, the actual return on plan assets as well as the possible effect of the asset ceiling are recognised in the net liability (asset) immediately against a credit or debit to OCI. These re-measurements will not be recycled to profit or loss subsequently. In IAS 19, a company could elect to apply the so called corridor approach to defer the recognition of some actuarial gains and losses. Alternatively, actuarial gains and losses could be recognised immediately in profit or loss.

In practice, a large number of companies have elected to defer the recognition of actuarial gains and losses in order to smoothen the reported results and therefore this revision will significantly impact the financial statements of these companies, specifically the net liability (asset), OCI and therefore also equity. Due to the fact that re-measurements are no longer recognised in profit or loss, the volatility in profit or loss will probably be reduced. However, the expected increase in volatility in both equity and post-employment liabilities will have impacts on solvency ratios and other equity related performance indicators as well as on dividend pay-out possibilities (see example in the frame on page 12).

Depending on the size of the expected financial impact, companies might consider, for example, revising certain ratios currently included in covenants underlying finance arrangements. Heavily impacted companies might even reconsider their post-employment package currently offered to their employees. Also, companies might reconsider the investment strategy for the plan assets. Equity investments tend to produce more volatile results than generally more stable results on bonds, and every up or downswing in the actual plan asset results needs to be recognised immediately under IAS 19R. These lower risk profile investment strategies might lead to lower returns on the plan assets, which in turn could lead to necessary increases in the pension contributions and, therefore, increase in the cash outflow related to pension premiums paid by companies.

All in all, it seems that this aspect of IAS 19R might also make the management of the company reflect more deeply on its risk and return choices regarding the assets underlying the defined benefit plans. As the reportable benefit of high risk/high return investments is significantly reduced, this will no longer be part of the investment strategy decision and therefore the investment decision seems to be more closely related to the actual aim - sound balancing of the financial risks and returns for both the company and all participants in the benefit plans.

b) Revised calculation and presentation of finance costs

After the amendment, the net interest will simply be calculated by applying the discount rate to the net defined benefit obligation (asset). The discount rate is generally based on the yield on high quality corporate bonds. The expected return on plan assets currently included in finance costs has been removed in IAS 19R. Therefore, the actual composition of the plan assets will no longer have any influence on reported net finance costs. The larger the difference between the currently used expected return on assets and the discount rate, the larger the effect on reported finance costs will be. In general, the amendment will lead to higher finance costs as the expected return of assets is normally higher than the discount rates to be applied under IAS 19R. Companies might need to reconsider their current covenants included in finance arrangements when based on interest coverage ratios (see example in the frame on page 12). Also, in some instances, the effects of higher finance costs and therefore lower net results on, for example, employee profit sharing schemes need to be investigated.

c) Past service costs to be recognised in profit or loss immediately at plan amendment

All past service costs, whether already vested or not, will be recognised immediately. Previously, unvested past service costs could be deferred and recognised on a straight-line basis over the remaining service period until the benefits became vested.

d) Revised definition for classifying employee benefits as short or long term

IAS 19R requires employee benefits to be classified as short term when the company expects to fully settle the benefit within 12 months after the end of the reporting period in which the related service by the employee is rendered. When the expectation is beyond 12 months, the benefit is classified as a long term benefit. As this changes the current classification guidelines, companies need to evaluate whether any reclassifications from short term to long term or vice versa will be needed. As the measurement requirements for short term and long term benefits differ, a reclassification might impact some financial ratios as well as impact future profits and other comprehensive income. However, it is worth noting that this classification does not affect the requirements for presentation as current or non-current liabilities in the Statement of Financial Position under IAS 1.

e) More extensive disclosure requirements on defined benefit plans

In order to increase insights into the effects of specific DB plans, the IASB included an extensive range of disclosure requirements related to DB plans in IAS 19R. These include an explanation of the characteristics and risks associated with DB plans, identification and explanation of DB related amounts in the financial statements and an explanation of the impact of the DB plan on the timing, amount and uncertainty of future cash flows of the company. Companies will need to review whether their current management information systems are able to provide all the required information and start implementing any revisions when necessary. Some critics might add that again companies need to revise their information systems in order to provide all requested disclosures, with all the associated costs to bear. This is true but, in the author's view, the additional disclosures should give the stakeholders of the company a more transparent overview of the impact the employee benefit plans have on the company. When communicated in a clear and timely manner, companies could even benefit from a decline in the degree of uncertainty as perceived by its investors, therefore, reducing the risk/uncertainty impairment investors would put on the equity price of the company when making investment decisions.

IAS 19R includes even more revisions than the highlights discussed above but these will only lead to significant impacts on the statement of financial position or reported results in individual cases. In general, the increase in disclosures and the elimination of the options regarding the recognition of actuarial gains and losses will improve the comparability of reported employee benefit expenses and make the risks associated with DB plans and related investment strategies more transparent - the black box is changing its colour! But all companies with material employee benefit related provisions in their financial statements should start to prepare for the impact of the revised IAS 19R at an early stage. Companies will need to review the impact on covenants, review whether the disclosure information can be retrieved from the current management information system and ultimately decide on whether the impact of the current benefits offered to the employees is still within acceptable limits³. An important part of the analysis will be the investment strategy as the higher risk equity investments no longer attribute to lower reported expenses in the profit or loss.

³Arguably, though, the management should always have been aware of the true cost of the scheme, and this is not changed by the way in which it has to be accounted for.

Example: interest coverage ratio

The interest coverage ratio is calculated as EBIT/Interest expense and is sometimes used in finance arrangements to set a minimum level of EBIT needed to cover the interest charges payable.

Assumptions:			
Discount rate	4%	Defined benefit obligation	2,500
Expected return on plan assets	5%	Fair value of plan assets	(1,000)
Interest expenses	100	Net defined benefit liability	1,500
EBIT	100		

The table below shows the different net finance costs and impact on the interest coverage ratio when applying the current IAS 19 or IAS 19R:

	IAS 19	IAS 19R	Difference
Interest expense	100	100	-
Interest income	-	(40)	(40)
Return on plan assets	(50)	-	50
Net finance costs	50	60	10
Interest coverage ratio	100/50 = 2	100/60 = 1.67	(0.33)

Due to the change to IAS 19R, the interest coverage ratio for this fictitious company has decreased from 2 to 1.67. As the covenants included a minimum of 2, the company now needs to negotiate a new covenant and/or take other measures to ensure no breach of the current covenant will occur.

Example: impact IAS 19R on solvency ratio

The following example shows the impact of the elimination of the option to defer unrecognised actuarial gains and losses on the solvency of Heineken N.V., a Dutch listed company, as of 31 December 2010 (all other figures remaining unchanged).

The annual report 2010 states the following accounting policy:

"In respect of actuarial gains and losses that arise, Heineken applies the corridor method in calculating the obligation in respect of a plan. To the extent that any cumulative unrecognised actuarial gain or loss exceeds ten per cent of the greater of the present value of the defined benefit obligation and the fair value of plan assets, that portion is recognised in profit or loss over the expected average remaining working lives of the employees participating in the plan. Otherwise, the actuarial gain or loss is not recognised."

The figures below have been derived from the annual report 2010 of Heineken N.V.:

As per 31.12.2010	(in € million)
Equity	10,517
Defined Benefit Liability	687
Total Liabilities	16,032

When solvency is expressed as the result of Equity/Total Liabilities, the resulting ratio amounts to $10,517/16,032 \times 100\% = 65.6\%$.

In the disclosures to the Defined Benefit Liability it is stated that the unrecognised actuarial gains and losses as per 31 December 2010 amount to €411 million.

When IAS 19R will be applied, these gains and losses should be recognised in other comprehensive income and therefore the revised figures would be as follows:

As per 31.12.2010	(in € million)
Equity	10,106
Defined Benefit Liability	1,098
Total Liabilities	16,443

Based on these revised figures after application of IAS 19R, the solvency ratio results in $10,106/16,443 \times 100\% = 61.5\%$. The elimination of the deferral option in IAS 19R would therefore deteriorate the solvency ratio by 4.1%.

**Timo van Eeden MSc RA is a Director in
RSM Nieuwe Lancée Kooij N.V.
The Netherlands**

**T: +31 6 20533043
E: tveeden@rsmnlk.nl**



Joelle Moughanni

Insurance Contracts Arrangements

After more than 13 years in the making, the International Accounting Standards Board (IASB) released in July 2010 its long-awaited exposure draft on insurance contracts with a comment period that ended in November 2010. Since February 2011, the Board has been re-deliberating the proposals.

By replacing IFRS 4⁴, the future IFRS aims at removing global diversity in practice and making it easier for users of financial statements to understand how insurance contracts affect the issuers' financial position and performance. The IASB is proposing a single model for recognition, measurement, presentation and disclosure of all types of insurance contracts (life and non-life). If endorsed, the proposals would fundamentally change insurers' accounting across the globe, affecting the timing of when insurers recognise profits, their net assets, their income statement presentation and, last but not least, their internal systems and processes.

This could have significant impact on insurers' organisation and the level of skills they would need to sustain financial reporting processes under the new regime. Closer relationships between finance and actuaries would be required and various stakeholders (policyholders, analysts, investors, regulators, providers of credit, etc.) would need to be educated on the implications of the new standard.

As the proposals are most likely going to be re-exposed in the 1st half of 2012 (or at least a Review Draft⁵ will be issued) and given their profound impact, now is the time to understand them and grasp their effect. To help with this, this article gives a summary of the most significant proposals under re-deliberation by the Board and their likely impact on current accounting practice.

An overarching principle

The IASB is proposing a comprehensive measurement approach for all types of insurance contracts issued (and reinsurance contracts held) by entities, with a modified approach for some short-duration contracts. The approach is based on the principle that insurance contracts create a bundle of rights and obligations that work together to generate a package of cash inflows (premiums) and outflows (benefits and claims). An insurer would apply to that package of cash flows a measurement model that uses four building blocks (as illustrated below).

Key proposal 1 – measurement

At the core of the future IFRS is a measurement model, under which the liability of all insurance contracts (except for certain short-duration contracts for which a simplified accounting approach would

be permitted) is determined by reference to the present value of the expected cash flows required to fulfil the obligation. The present value of expected cash flows is measured using the following four building blocks:

- » A current estimate of the future cash flows - This includes all cash flows relating to the existing contracts: insurance premiums, payments to policyholders, claims handling costs, direct policy administration and maintenance costs and any potential recoveries. All costs that an insurer will incur directly in fulfilling a portfolio of insurance contracts should be included in the cash flows used to determine the insurance liability
- » A discount rate reflecting the time value of money - In most circumstances, this is based on the risk-free rate of cash flows and adjusted for characteristics of the liability (e.g. illiquidity). For contracts where the cash flows depend wholly or partly on the performance of specific assets, the discount rate should reflect that dependency
- » An explicit risk adjustment - This reflects the uncertainty about the timing and amount of future cash flows. It represents the compensation the insurer requires for bearing the uncertainty inherent in the cash flows that arise as the insurer fulfils the insurance contract
- » A residual margin - This is an amount that eliminates any gain at the inception of the contract, will subsequently be adjusted for both favourable and unfavourable changes of the insurance liabilities (but cannot be negative) and it is allocated over the coverage period on a systematic basis that is consistent with the contractual pattern of transfer of services provided

All the building blocks are re-measured at each reporting period, the accounting model being based on current estimates (i.e. the estimates shall reflect all available information at the measurement date), rather than carrying forward estimates made at contract inception.

The model would use the expected value of future cash flows rather than a single, most likely outcome. Thus, not all possible scenarios need to be identified and quantified, provided that the estimate considers all relevant information.

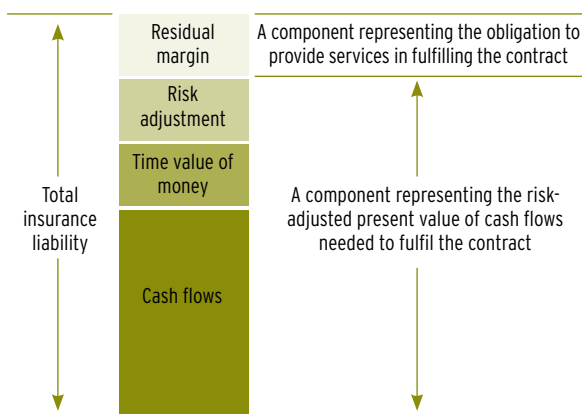
Put simply (see Illustration) and based on the latest re-deliberations of the Board, an insurer should measure an insurance contract as the sum of:

- (a) the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract, adjusted for the effects of uncertainty about the amount and timing of those future cash flows (i.e. present value of the fulfilment cash flows); and

⁴ IFRS 4 Insurance Contracts was the result in March 2004 of Phase I of the IASB's project. It is an interim standard that permits a wide variety of previous accounting practices for insurance contracts to continue until phase II is complete.

⁵ A Review Draft is an IASB Staff document that is published for the convenience of the general public without formally seeking comments.

(b) a residual margin that eliminates any gain at inception of the contract. A residual margin arises when the amount in (a) is less than zero (ie when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows). However, if the present value of the fulfilment cash flows is greater than zero (ie the expected present value of the future cash outflows plus the risk adjustment exceeds the expected present value of the future cash inflows), the insurer shall immediately recognise that amount in profit or loss as an expense. Thus, while day-one gains are prohibited, an insurer should recognise any loss on day one immediately in profit or loss.

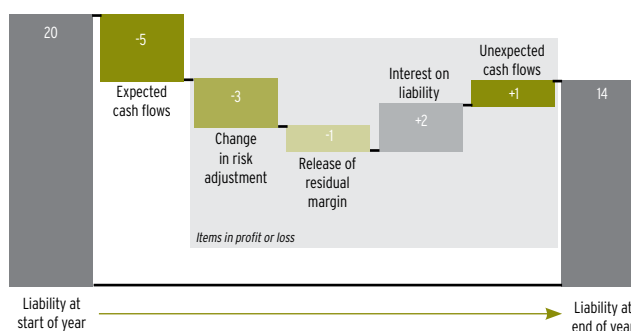


Source: IFRS Foundation website

The inclusion of an explicit risk adjustment is one of the most controversial aspects of the proposals and where the IASB and FASB seem to be definitively taking two different approaches. While the IASB insists on an explicit risk adjustment to cash flows and a residual margin to eliminate any initial gain on the contract, the FASB prefers a single composite margin, which is locked in at the inception of the contract and amortised over its period, with any changes recognised immediately in profit or loss. Whereas most insurers seem to support estimating cash flows at their present value and including a risk adjustment and residual margin, there has been strong opposition from some in relation to the explicit risk adjustment. Principally, their concerns centre on the concept that a risk margin is inconsistent with the overall framework of a fulfilment model, is hard to measure reliably and will reduce consistency and comparability of financial statements.

The requirement to estimate and explicitly report the four building blocks will prompt major system modifications and will expose insurers' sources of profit to a level of transparency not experienced before. In fact, the building block approach generates information

about the changes in the insurance liability and its performance during the period as illustrated below.



Source: IFRS Foundation website

Key proposal 2 – coverage period and contract boundary

Insurance contract assets and liabilities should initially be recognised when the coverage period begins, even if the insurer becomes a party to an insurance contract before then. However, if management becomes aware of onerous contracts in the pre-coverage period, an onerous contract liability should then be recognised.

The boundary of an insurance contract distinguishes the future cash flows that relate to the existing insurance contract from those that relate to future insurance contracts. A contract renewal should be treated as a new contract when the insurer is no longer required to provide coverage or when the existing contract does not confer any substantive rights on the policyholder. A contract does not confer on the policyholder any substantive rights when the insurer has the right or the practical ability to reassess the risk of the particular policyholder and, as a result, can set a price that fully reflects that risk.

This boundary is one of the key discussion topics by the IASB and FASB, who have attempted to find the balance between the legal form and substance of many insurance contracts, with the broad intention of not changing current market practice.

The new definition has gone some way to finding a solution that works for short and longer term duration contracts, but challenges remain. In particular, health insurers will need to look carefully at the wording of the definition and consider how it would apply to their business. In many countries, the current guidance essentially treats health insurance contracts as annual renewable contracts but this is likely to change under the proposals to allow for all future cash flows from a future policyholder over their expected lifetime. This is a complex change that, if implemented, should not be underestimated.

Key proposal 3 – unit of account

In addition to the proposed measurement model, the level at which insurers measure their insurance contracts is also important. This manifests itself in two key areas: the determination of the risk adjustment and an onerous contract test (commonly known as a liability adequacy test).

The IASB is proposing to determine the risk adjustment at the portfolio level (i.e. by grouping contracts subject to broadly similar risks which are managed together into a single pool), whereas current practice in many jurisdictions is to determine the risk adjustment at the entity level with full allowance for any diversification benefits. Many insurers and other interested parties argue that insurance is all about managing risk and that entity-wide diversification is integral to that. However, it appears that the IASB doesn't share this view and believes it difficult to measure diversification benefits consistently and reliably.

The proposed liability adequacy test is performed at the portfolio level, by contracts with a similar date of inception, whereas common current practice is to perform it at the portfolio level only. The proposal would lead to more loss recognition and increased volatility. Difficulties in interpreting what is meant by a 'similar inception date' and how to deal with products sold as packages or those that attract entity-wide loyalty discounts will be an area of focus for insurers.

In general, the final standard would measure insurance contracts at the portfolio level. However, the level of aggregation for the residual margin is still under re-deliberation.

Key proposal 4 – acquisition costs

Acquisition costs are expenses incurred by insurers to secure new contracts with policyholders. The only acquisition costs to be included in the initial measurement of a portfolio of insurance contracts would be direct acquisition costs, with no distinction between successful acquisition efforts and unsuccessful efforts (IASB is in favour of restricting acquisition costs to those related to successful efforts). Indirect costs (e.g. software dedicated to contract acquisition, agent and sales staff recruiting and training, advertising) would be expensed in the year in which they arise.

This might be a significant change from current practice for many insurers who defer most expenses (including internal costs) relating to the acquisition of a new business over the life of the contract.

Under the proposals, reported profits may vary depending on the nature of an insurer's distribution model. Thus, insurers who use independent intermediaries would be able to include commissions

in determining their future cash flows, whereas insurers with direct marketing or in-house sales forces may need to expense most of these acquisition costs as incurred.

Insurers seem to have mixed views on this proposal. While most general insurers do not see this aspect of the proposals as a big issue because the timing difference will unwind over 12 months, life insurers with contracts of a much longer duration believe this is a particularly significant issue, as there might be a significant drop in their net assets if this proposal is endorsed.

Other significant proposals

- » **Scope** - This is not an industry-specific project as it does not address all aspects of insurers' financial statements (e.g. financial assets backing insurance liabilities are accounted for under IFRS 9). The scope is at the insurance contract level, independently of the type of entity that issues it. It might concern, for example, banks and financial institutions (the boundary between financial instruments and insurance contracts is sometimes quite thin, e.g. financial guarantees). An entity will apply the IFRS to insurance contracts that it issues and reinsurance contracts that it holds (it will not apply to direct insurance contracts in which the entity is the policyholder). It would apply also to financial instruments that it issues containing a discretionary participation feature. A scope exclusion is under consideration for fixed fee service contracts (e.g. road-side assistance contracts and repair services).
- » **Unbundling** - Some insurance contracts contain one or more components that would be within the scope of another IFRS if the insurer accounted for those components as if they were separate contracts, for example, an investment (financial) component or a service component. If a component is not closely related to the insurance coverage specified in a contract, an insurer shall apply that other IFRS to account for that component as if it were a separate contract (i.e. shall unbundle that component). The IASB is currently considering whether non-insurance goods and services should be unbundled from an insurance contract in accordance with the principles for identifying separate performance obligations in the revenue recognition project.
- » **Bifurcating embedded derivatives** - An insurer should account separately for embedded derivatives contained in a host insurance contract that is not closely related to the embedded derivative. IFRS 9 applies to a derivative embedded in an insurance contract (unless the embedded derivative is itself an insurance contract): an entity is required to separate an embedded derivative from its host contract, measure it at fair value and recognise changes in its fair value in profit or loss.

**Joelle Moughanni is a Technical Consultant in the
RSM International Executive Office
T: + 44 (0)207 601 1089
E: joelle.moughanni@rsmi.com**

Global Contacts

Americas

Richard Stuart
T: +1 203 905 5027
E: richard.stuart@mcgladrey.com

Middle East

Chandra Sekaran
T: +965 2245 2680
E: chandra.sekaran@albazie.com

Europe

C.M. (Kees) Roozen
T: +31 (0)30 24 28 505
E: kroozen@rsmnederland.nl

Africa

Simon Fisher
T: +254 20 4451747/8/9
E: sfisher@ke.rsmashvir.com

Asia Pacific

Jane Meade
T: +61 2 8226 9518
E: jane.meade@rsmi.com.au

RSM Global Executive Office - UK

Ellen Costa
T: +44 (0)20 7601 1080
E: ellen.costa@rsmi.com

Editor

Dr Marco Mongiello ACA
Director MSc Management and MSc Innovation, Entrepreneurship & Management
Principal Teaching Fellow in Accounting
Imperial College Business School
T: +44 (0)20 7594 9686
E: m.mongiello@imperial.ac.uk

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