

# IFRS news

Emerging issues and practical guidance\*

Supplement – IFRS by industry

October 2010



## Hot topics in banking and capital markets

Financial services entities are facing a number of changes and challenges over the next few years. PwC's 'IFRS news' industry supplements will look at these as they affect banking, asset management and insurance entities over the next three issues. This month, Jessica Taurae of PwC's Global Accounting Consulting Services central team provides a comprehensive overview of recent and forthcoming developments in accounting that will have significant implications for the banking industry.

It is well known that the IASB has a full agenda, and a significant amount of the proposed changes relate to financial instruments. Banks' balance sheets are littered with financial instruments, so management needs to consider the impacts of these projects, which are expected to be completed by June 2011. Table 1 below outlines the expected timeline.

### In this issue...

- 2 Classification and measurement of financial assets
- 3 Impairment
- 4 Financial liabilities
- 5 Hedge accounting
- 6 Offsetting
- 6 Derecognition – disclosures
- 7 Fair value measurement – disclosures
- 7 Leasing
- 8 Insurance
- 9 Consolidations

**Table 1**

Topic	Exposure draft	Target date IFRS	Effective date
Classification and measurement of financial assets	July 2009	IFRS 9 published November 2009	1 January 2013
Classification and measurement of financial liabilities	May 2010	Expected Q4 2010	1 January 2013
Impairment and amortised cost	October 2009	Expected Q4 2010	No earlier than 1 January 2013
Hedge accounting	Expected Q4 2010	Expected Q2 2011	No earlier than 1 January 2013
Derecognition – disclosures	March 2009	Amendments to IFRS 7 published September 2010	1 July 2011
Offsetting	Expected Q4 2010	Expected Q2 2011	TBC
Fair value measurement disclosures	June 2010	Expected Q1 2011	TBC
Leasing	August 2010	Expected Q2 2011	TBC
Insurance	July 2010	Expected Q2 2011	No earlier than 1 January 2013
Consolidations	December 2008	Expected Q4 2010	TBC

### Classification and measurement of financial assets (IFRS 9)

ED published July 2009	IFRS 9 issued November 2009	Effective 1 January 2013
---------------------------	--------------------------------	-----------------------------

The IASB has accelerated its project to replace IAS 39, 'Financial instruments: Recognition and measurement', and subdivided it into three main phases. The IASB completed part of the first phase of this project on the classification and measurement of financial assets and issued IFRS 9, 'Financial instruments', in November 2009.

IFRS 9 replaces the multiple classification and measurement models for financial assets in IAS 39 with a model that has only two classification categories: amortised cost and fair value. Classification under IFRS 9 is driven by the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial assets.

A financial asset is measured at amortised cost if two criteria are met:

- the objective of the business model is to hold the financial asset for the collection of the contractual cash flows; and
- the contractual asset's cash flows solely represent payments of principal and interest.

IFRS 9 removes existing IAS 39 categories – notably the held-to-maturity and available-for-sale categories – and the tainting rules associated with the former. It also removes the requirement to separate embedded derivatives from financial asset hosts. It requires a hybrid contract to be classified in its entirety at either amortised cost or fair value.

Two of the existing three fair value option criteria become obsolete under IFRS 9, as a fair value driven business model requires fair value accounting, and most hybrid contracts are classified in their entirety at fair value. The remaining fair value option condition in IAS 39 is carried forward to the standard – that is, management may still designate a financial asset as at fair value through profit or loss on initial recognition if this significantly reduces an accounting mismatch. The designation at fair value through profit or loss continues to be irrevocable.

IFRS 9 prohibits reclassifications between amortised cost and fair value through profit or loss except when the entity's business model changes.

There is specific guidance for contractually linked instruments that often create concentrations of credit risk; the most common examples are investment tranches arising from a securitisation. In addition to assessing the instrument itself against the IFRS 9 classification criteria, management should 'look through' to the underlying pool of instruments that generate cash flows to assess their characteristics. The investment must have equal or

lower credit risk than the weighted average credit risk in the underlying pool of instruments to qualify for amortised cost; and those instruments must meet certain criteria. If 'a look through' is impracticable, the tranche should be classified at fair value through profit or loss.

IFRS 9's classification principles require all equity investments to be measured at fair value. However, management has an irrevocable option to present in other comprehensive income unrealised and realised fair value gains and losses on equity investments that are not held for trading. The election is available at initial recognition on an instrument-by-instrument basis, with no recycling to profit or loss except for dividends that are a return on investment in accordance with IAS 18, 'Revenue'.

IFRS 9 removes the cost exemption for unquoted equities and derivatives on unquoted equities, but provides guidance on the limited circumstances when cost may be an appropriate estimate of fair value.

IFRS 9 will have a significant impact on banks, as they hold a substantial amount of financial assets. Table 2 summarises typical financial assets held by the banks and the implications of IFRS 9 on their accounting.

Banks should familiarise themselves with the detailed requirements of IFRS 9 and evaluate the effects of the new standard on the classification and measurement of their financial assets. Banks will need to develop an understanding of the business model under which financial assets are managed. In particular, banks will need to assess their liquidity portfolios to determine how they are managed. They will also need to understand the nature of the cash flows of debt instruments to determine the appropriate classification and measurement for these financial assets. Investments in asset-backed securities will require a 'look through' approach; it may take a significant amount of time to analyse the underlying pool of assets to see if they meet the IFRS 9 requirements to be measured at amortised cost.

Banks should also consider the effects of these changes on their corporate customers. Some corporate entities may look to invest in more simple debt instruments in the future so as to avoid having to measure them at FVTPL. This could have a significant impact on the revenue of a bank where it earned substantial fees for structuring complex investments for its clients in the past.

Banks should also bear in mind that the financial instruments project is evolving. The IASB has indicated that the effective date of IFRS 9 may be pushed back to align the mandatory adoption of the standard with the effective dates for IAS 39 replacement stage II – 'Amortised cost and impairment' and 'Insurance' projects.

**Table 2**

Type of instrument	Accounting under IAS 39	Accounting under IFRS 9
Loans to customers	Amortised cost.	Measured at amortised cost or fair value through profit or loss depending on the bank's business model and contractual cash flows.
Equity investments not held for trading	AFS with fair value gains and losses deferred in OCI until realised or impaired.	FVTPL or FV through OCI (if elected with no recycling to profit or loss).
Government securities	AFS with fair value gains and losses deferred in OCI until realised or impaired.	Measured at amortised cost or fair value through profit or loss depending on the bank's business model and contractual cash flows.
Corporate bonds	AFS with fair value gains and losses deferred in OCI until realised or impaired.	Measured at amortised cost or fair value through profit or loss depending on the bank's business model and contractual cash flows.
Convertible bonds	AFS for debt host, FVTPL for the embedded derivative.	Entire bond at FVTPL.
Structured bonds	Loans and receivables for debt host; FVTPL for the embedded derivative.	Entire bond at FVTPL.
Collateralised debt obligations (CDOs)	Cash CDOs normally treated as loans and receivables or AFS; synthetic CDOs either at FVTPL or loan plus embedded credit derivative.	Cash CDOs may still be able to be measured at amortised cost depending on the bank's business model. Synthetic CDOs at FVTPL.
Asset backed securities	Loans and receivables or AFS depending on whether they are considered quoted in an active market.	Will require a 'look through' approach to the underlying pool of assets to determine whether FVTPL or amortise cost is appropriate.

Banks should monitor the IAS 39 replacement project and consider the impact of further decisions in the context of requirements already established by IFRS 9.

### Impairment

ED published October 2009	Final IFRS expected Q4 2010	Effective no earlier than 1 January 2013
------------------------------	--------------------------------	---

The IASB proposed fundamental changes to the impairment guidance for financial assets accounted for at amortised cost in October 2009. This is the second phase of the replacement of IAS 39. These proposals may have the greatest impact on banks given the significance of their lending activities.

The ED addresses a major criticism of the current accounting model in that the incurred loss approach delays the recognition of impairment until there is objective evidence that impairment has occurred. Impairment is to be recognised based on loss expectations, which will allow entities to start providing for impairment earlier than under the incurred loss model.

The proposed approach is built on the premise that interest charged on financial instruments includes a premium for expected losses, which should not be included as part of interest revenue/income, and results in an allocation of the initial estimate of expected credit losses over the expected life of the financial asset. The lender will be required to identify the

'effective interest rate' (EIR) component at the inception of an instrument that represents compensation for the expected losses. Interest income is recognised over the life of the instrument at the EIR, net of the expected loss component identified at inception. The premium associated with the expected losses is reflected each period as a reduction in the basis of the receivable (effectively a provision for bad debts).

Unlike the incurred loss model currently required under IAS 39, the ECF approach does not wait for objective evidence that an impairment has occurred; it instead requires a continuous assessment of the expected cash flows over the life of the instrument. No impairment losses will be recognised if the original expectations of the expected losses prove accurate. The premium associated with the initial estimate of expected losses will have already reduced the receivable balance to the amount expected to be collected. However, if more losses are expected than originally estimated, an impairment charge is recognised for the decrease in the expected cash flows. A credit to income is recognised if there is an increase in expected cash flows. The approach requires the use of allowance account for credit losses. Direct write-offs are prohibited.

The IASB recognised that there are significant operational challenges in implementing and applying the ECF approach. Estimating cash flows over the life of the instrument and the complexity of the EIR methodology are considered to be two of the most difficult areas. The IASB therefore set up an Expert

Advisory Panel to advise the Board on the operational issues surrounding application of the ECF approach and possible practical expedients.

The comment period closed in June. The Panel met six times during the comment period and provided a summary of its discussions to the IASB for consideration during its redeliberations, which have now begun.

Tentative decisions that have been made to date are:

- to move forward using an expected loss impairment approach;
- to consider an expected loss approach based on lifetime expected losses;
- that entities should consider all reasonable and supportable information (including forecasts of future conditions) when calculating expected losses, which is consistent with estimating cash flows projections for calculating value in use in IAS 36;
- to proceed with developing an approach that allocates the initial lifetime expected loss over the life of the portfolio; and
- to permit the use of a more operational 'decoupled' effective interest rate (that is, the expected loss estimate and effective interest rate are calculated and accounted for separately over the life of the portfolio) rather than an integrated EIR as proposed in the ED.

The ED also set out robust presentation and disclosure requirements, including loss triangles and vintage-based disclosures, to ensure that users can evaluate the financial effect of interest revenue and interest expense, and the credit quality of financial assets held by the entity. However, many commentators expressed concerns that the presentation and disclosure requirements are too onerous and voluminous and are not equally applicable to all types of loans. We expect the IASB to reconsider these requirements in light of the comments received and to reflect any changes they make to the impairment model itself.

It took a significant amount of time and effort when the banks moved to the incurred loss model when they first moved to IFRS. They should therefore expect that moving to this new impairment model will not require any less time and effort, and perhaps significantly more. Banks should follow the redeliberations of the IASB closely and start to consider now how they will implement this change in impairment methodology.

#### Financial liabilities

ED published May 2010	Final IFRS expected Q4 2010	Effective 1 January 2013
--------------------------	--------------------------------	-----------------------------

The IASB issued an ED in May 2010 addressing the classification and measurement of financial liabilities under

IFRS. The comment period is now closed, and the IASB has begun its redeliberations with the expectation of issuing a final IFRS in Q4 2010.

Banks have in the past designated a significant amount of their own issued debt as fair value through profit or loss (FVTPL) in lieu of having to separate out non-closely related embedded derivatives. The main concern regarding such liabilities is the impact of 'own credit' on the liability's fair value – that is, fluctuations in value due to changes in the liability's credit risk, in the income statement. This can result in gains being recognised in income when the liability has had a credit downgrade, and losses being recognised when the liability's credit risk improves. Many users find this result counterintuitive, especially when there is no expectation that the change in the liability's credit risk will be realised.

As a result, the ED proposed, and the IASB has reconfirmed during its redeliberations, that the accounting remain the same as in IAS 39 except where the financial liabilities are designated at FVTPL.

In addition, the IASB has decided for all liabilities designated under the fair value option, the effects of changes in a liability's credit risk will be required to be presented in other comprehensive income rather than in profit or loss, as currently under IAS 39, unless such treatment would create a mismatch in profit or loss. If such a mismatch would be created, the entire fair value change would be required to be presented in profit or loss. To make that determination about mismatches, an entity would assess whether it expects that the effects of changes in the liability's credit risk will be offset in profit or loss by a change in the fair value of an asset. An entity would make that determination at initial recognition, and it would not be reassessed. An entity will be required to disclose the basis for its determination in the notes to the financial statements and to apply it consistently.

The ED proposed – and the IASB reconfirmed – that the amount recognised in OCI would not be transferred to profit or loss if that liability was extinguished early; that is, there will be no recycling of the changes in own credit risk recognised in OCI when they are 'realised'.

Financial liabilities that are required to be measured at FVTPL (as distinct from those that the entity has chosen to measure at FVTPL) will continue to have all fair value movements recognised in profit or loss. This includes all derivatives, such as foreign currency forwards or interest rate swaps, or a bank's own liabilities that it holds in its trading portfolio, as well as issued loan commitments and financial guarantee contracts.

The guidance in IFRS 7, 'Financial instruments: Disclosures', will continue to be used for the purposes of determining the amount

**Table 3**

Issue	Current IAS 39	Tentatively proposed
Fair value hedge mechanics	The gain or loss on the hedged item attributable to the hedged risk adjusts the carrying amount of the hedged item and is recognised in profit or loss. The gain or loss on the hedging instrument is also recognised in profit or loss.	The gain or loss on the hedged item attributable to the hedged risk is presented as a separate line item in the balance sheet within assets (or liabilities) for those reporting periods for which the hedged item is an asset (or liability). The fair value hedging instrument changes of the and the hedged item attributable to the hedged risk are recognised in other comprehensive income, and any ineffectiveness (ie any difference) is transferred immediately to profit or loss.
Ineffectiveness	All hedge ineffectiveness should be measured and recognised in profit or loss.	All hedge ineffectiveness should be measured and recognised in profit or loss based on a dollar-offset approach, considering the actual performance of the hedged item and hedging instrument.
Effectiveness assessment	Quantitative – expected to be highly effective (80-125%) both at inception and on an ongoing basis.	Qualitative or quantitative depending on entity's risk management – both at inception and on an ongoing basis, the hedging relationship is expected to achieve offsetting of changes between the hedged item and the hedging instrument that are attributable to the hedged risk. This should also produce an unbiased result and minimise expected ineffectiveness

of change in a liability's fair value that is attributable to changes in its credit risk, with some additional examples and clarifications to be provided in the final standard.

As it was primarily the banks that took advantage of using the fair value option on their own liabilities, this ED will remove some of the billions of dollars of gains and losses recently seen flowing through banks income statements.

### Hedge accounting

ED expected Q4 2010	Final IFRS expected Q2 2011	Effective no earlier than 1 January 2013
---------------------	-----------------------------	--

Hedge accounting is the third phase of the project to replace IAS 39. The objective of this phase is to improve the decision-usefulness of financial statements for users by fundamentally reconsidering the current hedge accounting requirements for both financial and non-financial items.

The IASB has started making some tentative decisions regarding hedge accounting with the expectation of issuing an ED in Q4 2010. Table 3 outlines the main differences from IAS 39 that are being proposed that may have an effect on banks' own hedge accounting.

The IASB has yet to make any decisions regarding portfolio fair value hedging of interest rate risk, which has always been seen as one of the more controversial aspects of hedge accounting for banks. In Europe, a portion of the guidance on hedge

accounting was carved out to allow banks to hedge portfolios of financial assets and liabilities, which was consistent with their risk management strategies. The IASB is expected to consider how to address the many issues that this type of hedging presents (for example, hedging core deposits, prepayable fixed rate assets, 'pipeline mortgages') as part of this phase of the replacement project for IAS 39.

The IASB has also made some other decisions that, while they might not affect a bank's own hedge accounting, would be something to consider from a business perspective where banks help their corporate clients achieve hedge accounting for their risks. See table 4.

The IASB has also made some tentative decisions about what it does not believe should be permitted in its new hedging model:

- hedging equity investments that are measured at fair value through OCI;
- using derivatives embedded in financial assets as hedging instruments; and
- using internal derivatives as hedging instruments in consolidated financial statements.

Consistent with IAS 39, non-derivative financial instruments will continue to be eligible as hedging instruments for FX risk; however, the Board has yet to make a decision and requested further analysis from the staff on whether to allow cash instruments measured at FVTPL to be eligible as hedging instruments for other risks as well.

**Table 4.**

Issue	Current IAS 39	Tentatively proposed*
Hedging of risk components of non-financial hedged items where the portion is separately identifiable and measurable.	Prohibited except for foreign exchange risk	Permitted
Hedging contractually-specified risk components of non-financial hedged item	Prohibited	Permitted
Hedging a net position of forecast transactions	Prohibited	Permitted
Hedging a 'layer' of an entire item	Prohibited	Permitted
Basis adjustments	Accounting policy choice to keep in OCI or adjust carrying value of hedged item	Requires adjustment of the carrying value of hedged item
Hedges of FX risk of firm commitment as either fair value hedge or cash flow hedge	Permitted	Permitted
Derivatives as hedged items (eg when hedged exposure is combination of a derivative and non-derivative)	Prohibited	Permitted

\*The IASB has expressed a desire for these issues to be permitted; however, it is not yet clear how the IASB will operationalise or articulate these decisions in the ED.

Banks should continue to follow this debate, as it will not only affect their own accounting but will present opportunities to assist corporate entities in structuring qualifying hedging relationships that are more consistent with how they manage their risks in the future.

### Offsetting

ED expected Q4 2010	Final IFRS expected Q2 2011	Effective date TBC
---------------------	-----------------------------	--------------------

The IASB is planning on issuing an ED in Q4 2010 in response to stakeholders' concerns. The ED is expected to propose changes to address differences between IFRS and US GAAP on balance sheet netting of derivative contracts and other financial instruments. This is one of the more significant financial instrument presentation differences between IFRS and US GAAP for banks and can result in material difference in their balance sheets.

Under both IFRS and US GAAP, an entity can generally only net a recognised financial asset and financial liability if the entity has a legally enforceable (unconditional) right to offset and intends to offset those positions.

However, US GAAP has an exception that permits the netting of derivative balances if they are transacted with the same counterparty under a master netting agreement. This exception stresses that net presentation is justified when a master netting arrangement exists because the net presentation reflects the amount of credit risk exposure under that arrangement. IFRS permits netting only when doing so reflects an entity's expected future cash flows from settling two or more separate financial

instruments. In other words, if in practice derivatives transacted between the same counterparty under a master netting agreement are settled on a gross basis, they should not be presented net in the financial statements.

Should the IASB move to the US GAAP approach for netting derivatives, trillions of dollars of derivatives will be removed (that is, netted) from the balance sheets of banks.

The IASB has begun discussing when offsetting financial assets and liabilities in the statement of financial position provides useful information or is appropriate. No decisions have been made to date.

Given the significant change this might make to a bank's balance sheet under IFRS as well as its regulatory capital ratios, banks should follow the progress of this project and consider responding to the ED when issued.

### Derecognition – disclosures

ED issued March 2009	Amendments to IFRS 7 expected October 2010	Effective 1 July 2011
----------------------	--	-----------------------

The IASB issued an ED in March 2009 proposing to amend the derecognition requirements in IAS 39. The response letters received from constituents did not support the proposed approach. In addition, many respondents questioned why the IASB was looking to amend the requirements when they held up well during the financial crisis. As a result of that and the FASB's issuance of SFAS 166, which reduced some of the GAAP differences, the IASB abandoned its proposals on derecognition

accounting for now and is instead focussing in the near term on improving and converging the disclosure requirements in this area.

Amendments to IFRS 7 are expected shortly. The objective of these new requirements is to help users of financial statements evaluate the risk exposures and the effect of those risks on an entity's transferred financial assets, particularly those that involve securitisation of financial assets. Some of the disclosures we are expecting to be included in the amendments for assets that have been derecognised but for which the bank has some ongoing relationship with those assets (for example, a written put option and a senior note from a securitisation transaction) are:

- the fair value of the assets and liability that represent that ongoing relationship;
- the maximum exposure to loss from that relationship;
- the undiscounted cash outflows that would be required to repurchase derecognised assets; and
- a maturity analysis of those undiscounted cash outflows showing the remaining contractual maturities of that relationship.

Banks in particular undertake a significant number of structured transactions, including securitisations, and therefore have to begin the effort of pulling together the required information to present in those disclosures now. Banks should not underestimate the amount of time it will take to gather the data to support these new disclosure requirements. The requirements are effective for annual periods beginning on or after 1 July 2011; they will therefore be required in the 2012 financial statements of calendar-year entities, although comparative information for 2011 is not required.

#### FV measurement – disclosures

ED issued June 2010	Final IFRS expected Q1 2011	Effective date TBC
------------------------	--------------------------------	--------------------

The IASB has been working with the FASB to produce a converged standard on fair value measurement. In general, we do not expect the final fair value measurement standard itself to require significant changes in how banks determine the fair value of their financial instruments. However, the IASB has re-exposed its proposals for fair value measurement disclosures, which if retained would require significant additional effort to prepare. The ED has put forward an additional requirement for the entity to consider the expected effect of correlation between inputs when performing the uncertainty analysis. In other words, it would no longer be possible to ignore the interdependencies between input variables. For example, if changing an assumption about credit spreads implies a corresponding change in an assumption about pre-payment rates, the uncertainty analysis should take this into account. In contrast, under the proposals in the May 2009 ED, the uncertainty analysis could have been performed by holding the

pre-payment rate constant while changing the assumption about credit spreads.

This proposed amendment might alter the disclosures that a bank will be required to make if it has or will have assets or liabilities measured at fair value and categorised in Level 3 of the fair value hierarchy. Consideration of the effects of correlation between possible inputs could require significant additional effort, depending on the number and nature of inputs and the complexity of the valuation model used.

The comment period for the ED closed in September 2010; the IASB plans to begin redeliberating the issues in October. Many respondents expressed concerns about the proposed measurement uncertainty analysis disclosure. They are concerned in particular about the practical implications (for example, systems changes) necessary to develop the disclosure and whether such aggregated information would be meaningful for users of financial statements.

It is not yet clear what the effective date of these requirements will be; however, banks should continue to monitor the progress of this project.

#### Leasing

ED issued August 2010	Final IFRS expected Q2 2011	Effective date TBC
--------------------------	--------------------------------	--------------------

The IASB's proposed a new approach to lease accounting (see *IFRS news*, September, p1) would significantly change the way entities account for leases. The key objective is to ensure assets and liabilities arising from lease contracts are recognised in the balance sheet.

The proposed model will eliminate off-balance-sheet accounting for leases. All assets currently leased under operating leases will be brought onto the balance sheet, removing the distinction between finance and operating leases. The new asset represents the right to use the leased item for the lease term. The liability represents the obligation to pay rentals. These will be recognised and carried at amortised cost, based on the present value of payments to be made over the term of the lease. The lease term will include optional renewal periods that are 'more likely than not' to be exercised. Lease payments used to measure the initial value of the asset and liability will include 'contingent' amounts, such as rents based on a percentage of a retailer's sales or rent increases linked to variables such as the Consumer Price Index (CPI). The proposed model will require lease renewal and contingent rents to be continually reassessed and the related estimates to be trued up as facts and circumstances change.

Income statement 'geography' and timing of recognition will change. Straight-line rent expense will be replaced by depreciation, which will be recognised on a basis similar to

similar owned assets, and interest expense, which will be recognised on an effective interest basis.

Banks are often lessors as well. The boards were unable to agree upon a single lessor accounting model and decided that concerns about the application of each of the two approaches in certain fact patterns could only be addressed through a dual model.

- For leases where the lessor retains exposure to significant risks or benefits associated with the leased asset either during the term of the contract or subsequent to the term of the contract, the 'performance obligation' approach would be followed. The lessor recognises the underlying asset and a lease receivable, representing the right to receive rental payments from the lessee, with a corresponding performance obligation, representing the obligation to permit the lessee to use the leased asset.
- For all other leases, the 'derecognition approach' would be followed. The lessor recognises a receivable, representing the right to receive rental payments from the lessee and records revenue. In addition, a portion of the carrying value of the leased asset is viewed as having transferred to the lessee and is derecognised and recorded as cost of sales.

Similar to lessee accounting, lessors under either approach would also need to estimate the lease term and contingent payments and true-up these estimates as facts and circumstances change.

The change may have a pervasive impact for banks:

- Banks often lease significant amounts of real estate for their branches and head offices, which will now be required to be reported as a gross asset and liability on the balance sheet.
- Banks often run leasing businesses that structure asset finance arrangements for their customers, such as sale and leaseback transactions. Such transactions result in the removal of the underlying assets from the customer's balance sheet often with associated tax benefits. This may no longer be allowed and may therefore result in a loss of business income for the banks.
- As the banks' balance sheets grow, leverage ratios will increase and capital ratios will decrease; the adequacy of regulatory capital, which continues to be an area of particular focus in the current environment, will need to be assessed.
- The changes in metrics may also affect loan covenants, credit ratings and other external measures of financial strength. Internal measures used for budgeting, incentive and compensation plans and other financial decisions may similarly be affected.

Given the potential impact of the proposed changes on accounting and operations, management should begin to assess the implications of the proposal on their existing contracts and current business practices. Banks should also consider commenting on the ED to ensure their views on the proposed changes are considered.

## Insurance

ED issued July 2010	Final IFRS expected Q2 2011	Effective no earlier than 1 January 2013
------------------------	--------------------------------	--

The IASB issued an ED in July 2010 of a comprehensive standard that will fundamentally change the accounting by insurers and other entities that issue contracts with insurance risk (see *IFRS news*, September 2010, p2).

The ED retains the IFRS 4 definition of an insurance contract as 'a contract under which one party accepts significant insurance risk from another party by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder'.

Financial guarantee insurance, mortgage guarantee insurance, trade credit insurance, contracts and loans with waivers upon death of the borrower (that is, equity release mortgages) and some letters of credit often issued by banks will now be within the scope of the standard, as credit risk is omitted from the definition of financial risk and insurance is risk of loss other than from financial risk. However, contracts that pay out regardless of whether the counterparty holds the underlying debt instrument or on a change of credit rating or credit index will continue to be accounted for as financial instruments at fair value through profit or loss.

This proposed insurance contract accounting is different from the current accounting for financial guarantee contracts that are within the scope of IAS 39. Financial guarantees within the scope of IAS 39 are currently initially recognised at fair value and amortised to profit or loss in accordance with IAS 18, 'Revenue', unless a provision is required; this should be measured at the best estimate of the cash outflows required to settle the contract.

The proposals require all insurance contracts to use a current measurement model of the present value of expected cash flows to fulfil the obligation, where estimates are re-measured at each reporting period. This measurement model is based on the building blocks of discounted probability-weighted cash flows, a risk adjustment and a residual margin to eliminate any initial profit. The residual margin is not subsequently re-measured but is released in a systematic way over the coverage period. Any initial loss on a contract is recognised immediately in profit or loss.

The income statement will be driven by the measurement model. Issuers will not recognise premiums as revenue but will separately show an underwriting margin (comprising changes in the risk adjustment and residual margin) and changes in estimates and experience variances.

The proposals are likely to result in increased volatility and significant changes in the presentation of the income statement.

Given the changes being proposed, banks should begin to assess the implications of the new model on their existing contracts and should also consider commenting on the ED to ensure their views on the significant changes are considered.

### Consolidations

ED issued December 2008	Final IFRS expected Q4 2010	Effective date TBC
----------------------------	--------------------------------	--------------------

The new standard, when issued, will replace IAS 27, 'Consolidated and separate financial statements', and SIC-12, 'Consolidation – special purpose entities' (SPEs). The IASB has published a staff draft that includes the decisions made by the IASB following comment letters and the redeliberations of ED 10, 'Consolidated financial statements', which was published in December 2008 (see the main edition of this month's *IFRS news*, p1).

The IASB's staff draft of the proposed new consolidation standard changes the definition of control so that the same criteria are applied to all entities (both operating and SPEs) to determine control. The definition will be supported by extensive application guidance that addresses the different ways in which a reporting entity (investor) might control another entity (investee).

The revised definition will focus on the need to have both power and variable returns before control is present. Power is the current ability to direct the activities that significantly influence returns. Returns must vary and can be positive, negative or both.

The determination of power is based on current facts and circumstances and is continuously assessed. The fact that control is intended to be temporary does not obviate the requirement to consolidate any investee under the control of the investor. Voting rights or contractual rights may be evidence of power, or a combination of the two may give an investor power. Power does not have to be exercised. An investor with more than half the voting rights would meet the power criteria in the absence of restrictions or other circumstances.

The changed definition and application guidance is not expected to result in widespread change in the consolidation decisions made by IFRS reporting entities. However, banks will need to understand and consider the new guidance in the context of not only their own businesses but also the many and varied uses of SPEs they set up on behalf of their clients.

The IASB plans to issue its final standard in the fourth quarter of 2010. In addition, it is understood that extensive new disclosures will be required to highlight any relationships between the banks and unconsolidated SPEs. Banks should begin to prepare the data gathering exercise that will be needed to meet those new requirements.

### Other developments

If the above is not enough, there are a few other projects on the IASB's agenda due to be completed by June 2011 on revenue recognition, pensions and non-financial liabilities that may also impact bank's financial reporting.