IFRS news
November 2018

Must know

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IASB amends definition of business in IFRS 3

At a glance

On 22 October 2018, the IASB issued amendments to the guidance in IFRS 3, 'Business Combinations', that revises the definition of a business. According to feedback received by the IASB, application of the current guidance is commonly thought to be too complex, and it results in too many transactions qualifying as business combinations.

What is the issue?

New guidance

To be considered a business, an acquisition would have to include an input and a substantive process that together significantly contribute to the ability to create outputs. The new guidance provides a framework to evaluate when an input and a substantive process are present (including for early stage companies that have not generated outputs). To be a business without outputs, there will now need to be an organised workforce.

The definition of the term 'outputs' is narrowed to focus on goods and services provided to customers, generating investment income and other income, and it excludes returns in the form of lower costs and other economic benefits.

It is also no longer necessary to assess whether market participants are capable of replacing missing elements or integrating the acquired activities and assets.

An entity can apply a 'concentration test' that, if met, eliminates the need for further assessment. Under this optional test, where substantially all of the fair value of gross assets acquired is concentrated in a single asset (or a group of similar assets), the assets acquired would not represent a business.

What is the impact and for whom?

The changes to the definition of a business will likely result in more acquisitions being accounted for as asset acquisitions across all industries, particularly real estate, pharmaceutical, and oil and gas. Application of the changes would also affect the accounting for disposal transactions.

Differences in accounting between business combinations and asset acquisitions include, among other things, the recognition of goodwill, recognition and measurement of contingent consideration, accounting for transaction costs, and deferred tax accounting.

When does it apply?

Entities shall apply these amendments to business combinations for which the acquisition date is on or after the beginning of the first annual reporting periods beginning on or after 1 January 2020 and to asset acquisitions that occur on or after the beginning of that period. Early application is permitted.

Amendments to IAS 1 and IAS 8 - Definition of material

At a glance

On 31 October 2018, the IASB issued amendments to the definition of material (amendments to IAS 1 and IAS 8).

Issue

Amendments to the definition of material

On 31 October 2018, the IASB issued amendments to the definition of material in IAS 1 and IAS 8.

The amendments to IAS 1, 'Presentation of financial statements', and IAS 8, 'Accounting policies, changes in accounting estimates and errors', and consequential amendments to other IFRSs: i) use a consistent definition of materiality throughout IFRSs and the Conceptual Framework for Financial Reporting; ii) clarify the explanation of the definition of material; and iii) incorporate some of the guidance in IAS 1 about immaterial information.

The amended definition is:

"Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity."

The amendment clarifies that the reference to obscuring information addresses situations in which the effect is similar to omitting or misstating that information. It also states that an entity assesses materiality in the context of the financial statements as a whole.

The amendment also clarifies the meaning of 'primary users of general purpose financial statements' to whom those financial statements are directed, by defining them as 'existing and potential investors, lenders and other creditors' that must rely on general purpose financial statements for much of the financial information they need.

Impact

The amendments clarify the definition of material and make IFRSs more consistent, but are not expected to have a significant impact on the preparation of financial statements.

When does it apply?

These amendments should be applied for annual periods beginning on or after 1 January 2020. Earlier application is permitted.

IASB agrees on criteria for evaluating any future potential amendments to IFRS 17

The IASB notes that a high hurdle will be set for any future amendments to IFRS 17

At a glance

On 24 October 2018, the Board unanimously agreed criteria for evaluating any future potential amendments to IFRS 17. The Board noted that the criteria set a high hurdle for change, and any amendments suggested would need to be narrow in scope and deliberated quickly to avoid significant delays in the effective date. In the coming months, the Board will discuss whether any amendments to IFRS 17 are justified, including a potential deferral of the effective date. If the Board decides to amend the standard, any amendments would be subject to the IASB Board's due process for amendments to IFRS standards, including developing an exposure draft and subsequent consultation period. The Board shared its concern about the temporary exemption from IFRS 9 if it were to defer the effective date for IFRS 17.

The views in this In transition are based on our observations from the 24 October meeting, and they might differ in some respects from the official minutes of the meeting to be published by the IASB at a later date.

Background

1. In connection with the issuance of IFRS 17, the IASB established a transition resource working group ('TRG') to provide a public forum for stakeholders to follow the discussion of questions raised on implementation of the new standard. The purpose of the TRG is to facilitate a public discussion to provide support for stakeholders, and information to the Board, on implementation questions arising from the application of IFRS 17.

2. After issuance of the standard, IASB staff have also been engaged in a variety of activities with stakeholders to follow the implementation of IFRS 17. During these activities, and through the TRG discussions, the staff have become aware of several instances where the standard might be interpreted in ways that were not intended by the Board. At the 24 October meeting, the IASB staff presented to the Board a list of 25 concerns and implementation challenges raised by constituents.

Items discussed at the IASB Board meeting

3. Four staff papers were prepared for the meeting (available here), including the TRG submission log and the IASB Summary from the September 2018 TRG meeting. The IASB Board had no comments on the September 2018 TRG summary prepared by the staff, and the discussion in the Board meeting was mainly focused on the criteria for any potential amendments to IFRS 17.

Criteria for evaluating possible amendments to IFRS 17

4. Subsequent to issuance of the standard, the IASB has received feedback from both preparers and users of financial statements. The staff noted that more than 500 users of financial statements have been interviewed, and the IASB has received positive feedback on the standard through this outreach.

5. The Board agreed that the following criteria, as identified by the staff, should be applied for evaluating whether IFRS 17 should be subject to any amendments:

- The amendment would not result in a significant loss of useful information relative to that which would have been provided by IFRS 17 for users of financial statements. Any amendment would avoid:
  - reducing the relevance and faithful representation of information in the financial statements of entities that issue insurance contracts;
  - causing reduced comparability or introducing internal inconsistency in IFRS standards, including within IFRS 17; or
  - increasing complexity for users of financial statements, thus reducing understandability.
- The amendment would not unduly disrupt implementation processes that are currently underway or result in undue delays in the effective implementation of IFRS 17.

6. In addition to the above criteria, Board members requested that the IASB staff expand the analysis on each topic raised by constituents, to consider the cost versus benefit analysis and to provide insight as to whether any new arguments or information are available, beyond what was already considered in deliberating the standard. That is, several Board members were unwilling to redebate any concerns unless new information that was not considered in the deliberations was presented by the staff.

7. The Board acknowledged the 25 topics identified as concerns and implementation challenges, and some Board members asked for clarification or further information on several of the topics. The IASB staff in future meetings will present separate submissions for each topic, setting out firstly whether there is a need to amend IFRS 17, and secondly whether the amendment satisfies the agreed criteria. The IASB staff emphasised that, even if the Board agrees that a potential amendment meets the criteria, it does not mean that amendments meeting these criteria will be made. That is, meeting the criteria will not automatically result in an amendment to the standard. Several Board members and staff also noted that they would need to look at any proposed amendments in aggregate, and not just individually.

8. Board members were reluctant to amend the standard, because they believe that it could lead to greater complexity, with many stating that the meeting had left them very disheartened at the thought of doing this. The Board did not comment on changes to the effective date of the standard, or whether IFRS 9 would continue to be deferred with IFRS 17. However, the IASB chairman did note his concern that, since insurers are very active in debt markets and some are searching for high-yielding debt, the impact of not implementing IFRS 9 would be difficult to accept. He went on to voice his concern that, if insurers had not implemented IFRS 9 by the next financial crisis, it would have severe repercussions.

Specific concerns and implementation challenges

9. The IASB staff recommended that the Board's assessment of whether there is a need to amend IFRS 17 should be balanced against the need to limit any such amendments other than those that meet specified criteria. As a basis for the discussion in the Board meeting, a 61-page document (available here) was prepared by staff, summarising the 25 concerns and implementation issues identified.

10. The Board provided comments on only some of the matters addressed below, and it was agreed that the discussion would continue in more detail at a future meeting, including addressing comments provided by the Board. The staff noted that the issues are listed in the order in which they appear in the standard.

Concerns raised	
1	Scope of IFRS 17: Loans and other forms of credit that transfer insurance risk
2	Level of aggregation of insurance contracts
3	Acquisition cash flows for renewals outside the contract boundary
4	Use of locked-in discount rates to adjust the contractual service margin
5	Discount rates and risk adjustment
6	Risk adjustment in a group of entities
7	Contractual service margin: coverage units in the general model
8	Contractual service margin: limited applicability of risk mitigation exception
9	Premium allocation approach: premiums received
10	Business combinations: classification of contracts
11	Business combinations: contracts acquired during the settlement period
12	Reinsurance contracts held: initial recognition where underlying insurance contracts are onerous
13	Reinsurance contracts held: ineligibility for the variable fee approach
14	Reinsurance contracts held: expected cash flows arising from underlying insurance contracts not yet issued
15	Separate presentation of groups of assets and groups of liabilities
16	Presentation in the statement of financial position: Premiums receivable
17	OCI option for insurance finance income or expenses
18	Definition of insurance contract with direct participation features
19	Interim financial statements: Treatment of accounting estimates
20	Date of initial application of IFRS 17
21	Effective date: Comparative information
22	Temporary exemption from applying IFRS 9
23	Transition: Optionality
24	Modified retrospective transition approach: further modifications
25	Transition-Fair value approach: OCI on related financial assets

Next step

11. The Board will continue its discussion in the forthcoming months, including whether there is a need to propose any changes to the standard. The IASB noted that it is too early to say whether these discussions will result in any proposals to change the standard. Any amendments to the standard will need to follow the IASB due process, which will include issuance of an exposure draft and a public consultation period. The IASB has already published a short note of the meeting that is available here.

PwC has developed the following publications and resources related to IFRS 17, 'Insurance Contracts':

- In transition INT2018-04: *TRG debates more IFRS 17 implementation issues*
- In transition INT2018-03: *Amendments to IFRS 17 on the IASB Board agenda*
- In transition INT2018-02: *Insurance TRG addresses unit of account, contract boundary, and coverage unit issues*
- In transition INT2018-01: *Insurance TRG holds its first meeting on IFRS 17*
- In brief INT2017-05: *IFRS 17 marks a new epoch for insurance contracts*
- In depth INT2017-04: *IFRS 17 marks a new epoch for insurance contract accounting*
- *Using Solvency II to implement IFRS 17*
- *IFRS 17 – Redefining insurance accounting*

PwC clients who would like to obtain any of these publications, or have questions about this In transition, should contact their engagement partner.

Issues of the month

PwC IFRS Blog

IFRS 17 : Important considerations for the legacy market

As IFRS17 comes sharper into focus for the insurance industry as a whole, it is becoming ever-clearer that the legacy insurance market will not escape its grasp. Potential changes to the way that profit from past and future transactions can be recognised on transition and in the future mean that it is critical that these changes are fully understood by legacy market participants in order to plan for the financial and operational impacts on your business.

What is changing?

It's no secret that the measurement of all insurance liabilities will change to a risk-adjusted discounted basis and that the current common practice of holding additional margins will no longer be allowed. This means that profit will emerge differently over time between current IFRS and IFRS17.

Of particular additional importance to the legacy market is that acquired or retrospectively reinsured portfolios of fully expired (run-off) contracts will have a new coverage period, equal to the settlement period of the liabilities, and the embedded profit from transactions will be released over this settlement period. This is in contrast to the current environment where profit may often be recognised on the transaction date.

Furthermore, this reassessment is retrospective, so on transition to the new standard, an acquirer's balance sheet will be restated to reflect this treatment for all unsettled historical transactions. It is worth noting that the topic of exactly how historical transactions should be treated on transition is an issue raised in the October 2018 IASB meeting.

What does this mean in practice for acquirers and sellers?

So what does this mean for the legacy market? The key takeaway is that under long-term reinsurance agreements and Part VII transfers, the ultimate profit will not change but IFRS17 could change the way that profit from transactions emerges over time, which could impact the perceptions of investors, dividend pay-out patterns, the KPIs that are used to value transactions and potentially even deal pricing for some insurers.

IFRS17 will also transform the presentation of your consolidated group financial statements on transition and in the future, and the entity financial statements to the extent that IFRS is used as the accounting basis in entity accounts. It will also lead to a balance sheet impact on transition so it is important to understand how historical transactions of business currently in the settlement period will be accounted for in the new world.

The move to IFRS17 can also impact the tax position of companies, especially where IFRS is used as the tax base (in the UK, this is the case if the financial statements are on IFRS). Transition could cause one-off profits or losses for tax purposes, and the ongoing profit profile may change for tax purposes. Even where companies do not use IFRS as the tax base, there may be deferred tax impacts to consider.

In addition to these headline impacts:

- Enhanced disclosure requirements will increase the transparency of reserve adequacy, expected profitability and quality of earnings, which could change the landscape of the deal market because buyers will have access to more information.
- Changes to financial statement presentation will drive new key performance indicators and MI requirements across the industry, for example deal metrics.
- All insurers operating in an IFRS17 world will require additional data and a more complex measurement model under IFRS17, introducing greater levels of system complexity and cost, with corresponding impacts upon finance and actuarial processes.

So what should you do now?

It remains to be seen whether IFRS17 will impact deal pricing but regardless of this, it is important for all run-off acquirers and disposers to understand the financial impact of IFRS17 on transition and on the accounting for future transactions. Further consideration of the key judgments available, plus the impact on data, systems, and processes will help companies assess the scale of the change and enable them to plan accordingly.

This week's guest blogger is Graham Oswald, PwC Director.

Connect with him on LinkedIn.

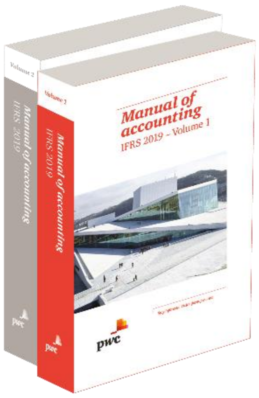
Word on the Wharf

You may have spotted that the IASB has moved from Cannon Street to Canary Wharf. So we have renamed 'Cannon Street Press' as 'Word on the Wharf'. But the content is the same, namely an overview of IASB and IFRS IC meetings.

The October 2018 IASB update has been published and the work plan updated.

The topics, in order of discussion, were:

- Disclosure Initiative: Accounting Policies
- Goodwill and Impairment
- Implementation: Deferred tax—tax base of assets and liabilities
- Insurance Contracts
- Management Commentary
- Rate-regulated Activities
- Updating the Preface to IFRS Standards
- Primary Financial Statements



Coming soon:
Manual of accounting - IFRS 2019
(Two-volume set)

Key updates includes:

- Amendments to IAS 19, 'Employee benefits'
  - Plan amendments , curtailment or settlement
- Annual improvements 2015 – 2017
- Amendments to IFRS 9, 'Financial instruments'
  - Prepayment features with negative compensation
- Amendments to IAS 28, 'Investments in associates'
  -Long term interests in associates and joint ventures
- Revised conceptual framework issued in March 2018

For more information visit www.pwc.com/manual

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