

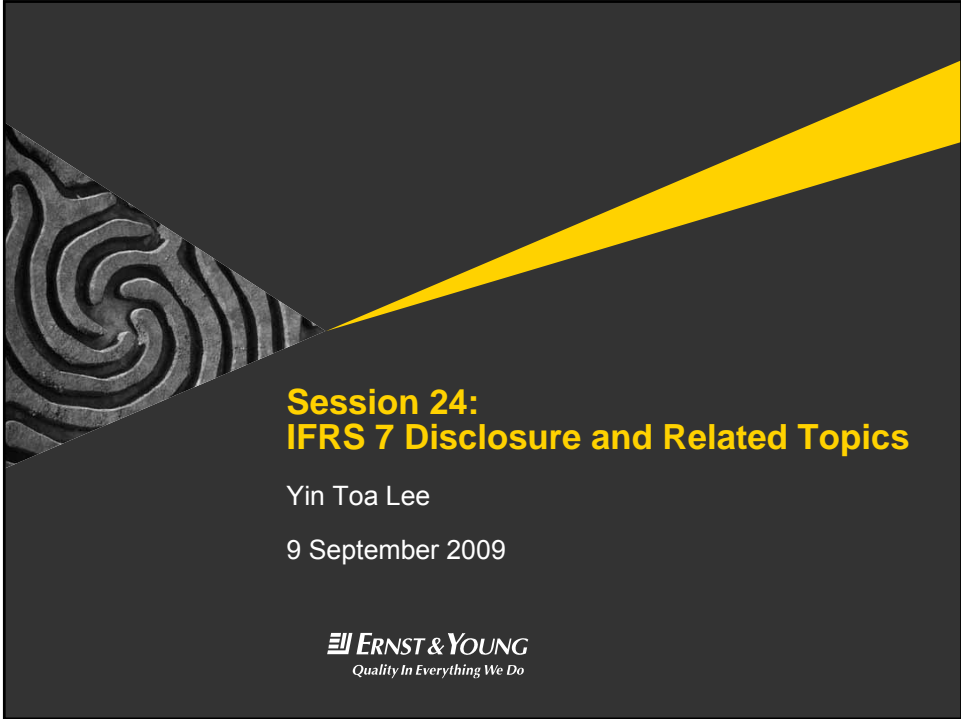


SOCIETY OF ACTUARIES

**International Financial Reporting for Insurers:
IFRS and U.S. GAAP Seminar
September 2009**

Session 24: IFRS Disclosure and Related Topics

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**Session 24:
IFRS 7 Disclosure and Related Topics**

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Agenda

- ▶ Overview and scope
- ▶ IFRS amendments 7 required for 2009
- ▶ Fair value disclosures
- ▶ What we have learned from US FAS 157 implementations for similar disclosures
- ▶ Liquidity disclosures
- ▶ Annual improvements to IFRS 7

IFRS 7 *Financial Instruments: Disclosures*

Subject matter covered:

Disclosures that enable users to evaluate:

- ▶ The significance of financial instruments for the entity's financial position and performance; and
- ▶ The nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks

IFRS 7 *Financial Instruments: Disclosures* (cont.)

Scope: generally IFRS 7 must be applied by all entities to all financial instruments except:

- ▶ Interests in subsidiaries (IAS 27), associates (IAS 28) and joint ventures (IAS 31)
- ▶ Rights and obligations under employment benefit plans (IAS 19)
- ▶ Contingent consideration in a business combination, if acquirer (IFRS 3)
- ▶ Financial instruments, contracts and obligations under share-based payment transactions (IFRS 2)
- ▶ Certain insurance contracts (IFRS 4)

IFRS 7 amendments – background and effective date

- ▶ Exposure Draft (ED) issued in October 2008, final amendments issued March 2009
- ▶ Changes enhance the disclosures about:
 - ▶ Fair value
 - ▶ Liquidity risk
- ▶ Disclosures required for annual periods beginning on or after 1 January 2009
 - ▶ ED proposed application for annual periods beginning after 1 July 2009 – the urgent need for enhanced disclosures drove earlier application
 - ▶ In first year of application, comparative information not required

IFRS 7 amendments - fair value disclosures

Hierarchy, by class, for financial instruments recorded at fair value:

- ▶ Three levels are:
 - ▶ Quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1)
 - ▶ Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly (as prices) or indirectly (derived from prices) (Level 2)
 - ▶ Inputs for the asset or liability that are not based on observable market data (unobservable inputs) (Level 3)
- ▶ Instrument should be classified in its entirety based on basis of lowest level that is significant to fair value
- ▶ Does not change measurement hierarchy under IAS 39
- ▶ The hierarchy is the same under US GAAP FAS 157
- ▶ 'Class' is one level lower than a category such as 'held for trading'

IFRS 7 amendments - fair value disclosures (continued)

Required disclosures of movements within the fair value hierarchy, by class:

- ▶ Significant transfers between Levels 1 and 2, including reasons for the transfers
- ▶ For level 3, a reconciliation of beginning and ending balances with:
 - ▶ Total gains or losses for the period split between P&L and OCI
 - ▶ Purchases, sales, issues and settlements (separately by each type of movement, not net)
 - ▶ Transfers into and out of Level 3, with 'significant' transfers in/out disclosed separately, along with reasons for the transfers
- ▶ Unrealised gains or losses for Level 3 instruments held at the end of the period – and where recorded (P&L or OCI)

IFRS 7 amendments - fair value disclosures (continued)

Reasonably possible alternative inputs of Level 3, by class:

- ▶ Disclosure of the impact of changing one or more inputs to reasonably possible alternative assumptions, if they would change fair value significantly
 - ▶ Significance should be based on the entity's profit/loss and total assets or liabilities
- ▶ Disclosure of how the effect of reasonably possible alternative assumptions was determined

Implications of IFRS 7 amendments

- ▶ Entities will need to modify processes, systems and internal controls to obtain the information required by the amendments

IFRS 7 fair value disclosures v. US FAS 157

The IFRS 7 amendments will require more onerous disclosure than those required by US FAS 157 which was adopted by US entities from 2007

- ▶ For Level 3 reconciliation
 - ▶ IFRS 7 requires the disclosure of purchases, sales, issues and settlements separately, with 'significant' transfers in/out disclosed separately and reasons for any transfers in or out of level 3
 - ▶ FAS 157 allows disclosures to be net and does not require reasons
- ▶ Transfers between levels 1 and 2
 - ▶ IFRS 7 requires disclosures of significant transfers between levels 1 and 2 and the reasons
 - ▶ FAS 157 does not require
- ▶ Disclosure of reasonably possible alternative assumptions
 - ▶ IFRS 7 requires disclosure of the impact of changing one or more inputs if they would change fair value significantly and how the effect of assumptions were determined
 - ▶ FAS 157 does not require, but some US entities have similar disclosures in their MD&A

Myths about FAS 157

- ▶ Once we determine accounting policy, the rest is simple!
- ▶ If we can create the initial FAS 157 disclosure, repeating the process quarterly will be no problem
- ▶ The disclosure and Level 3 roll-forward reports look relatively simple – it should be easy to produce
- ▶ The burden of implementation is on accounting policy and financial reporting
- ▶ Each financial instrument can be given a static level
- ▶ We can rely on the pricing/data vendors to determine level and provide it with our feed
- ▶ We can just buy a vendor software package to solve the FAS 157 challenges

Reality from our experiences from FAS 157 implementations in the US

- ▶ Successful implementation will require changes to accounting policies, processes, system and technology across the organisation
- ▶ Availability and sourcing of data from multiple systems (on and off-line) and reconciling with the general ledger
- ▶ Developing a comprehensive statement of data requirements
- ▶ Developing a sustainable process: transitioning from a manually intensive tactical approach to a more automated strategic solution
- ▶ Consistency of applying the fair value hierarchy
- ▶ The determination of 'significance' of inputs
- ▶ Documentation of evidence to satisfy audit and SOX

Considerations for determining levels in the hierarchy

- ▶ Consistent policies
 - ▶ Significance of input(s)
 - ▶ U.S. generally measures against balance sheet amount and P&L in certain cases
 - ▶ Diversity on whether bright line cut off (i.e. 10%)
 - ▶ Some utilize stress testing while others assess qualitatively
 - ▶ Active market
 - ▶ Definition based on frequency and volume
 - ▶ Some base policy on quantitative measures while remaining utilize qualitative factors
 - ▶ Potential new guidance on providing indicators of markets that are not active (both U.S. & IFRS)

Considerations for determining levels in the hierarchy (continued)

- ▶ Use of pricing services/broker quotes
 - ▶ Need to understand valuation methodology and process/challenges with pricing waterfall
- ▶ Allocation of portfolio-level reserves/adjustments

Considerations for determining levels in the hierarchy - automated vs. manual

- ▶ Manual Process
 - ▶ Need for strong controls, consistency and audit trail
- ▶ Automated
 - ▶ Better control environment, need exception report for items not levelled, more efficient
- ▶ Semi-automated
 - ▶ Data transformation – require consistent format
 - ▶ Centralise levelling process – at corporate vs. subsidiaries
 - ▶ Levelling logic – could build desktop tool within 2-3 months depending on the complexity and quality of your source; data could be imported into enterprise systems subsequently

Level 3 roll-forward considerations

Defining policies:

- Transfers in and/or out
- Unrealised gain/loss at end of period
- Year-to-date vs. period

Unique to IFRS: separately show purchases, sales, issues and settlements

- Need to capture further granularity

Storing levels for prior periods

Unrealised gains/losses recorded in the income statement (3 views)

- ▶ **View A – Specific allocation**
 - ▶ Realised gains and losses based on how actual settlements occur compared how expected
 - ▶ Realised gains and losses based difference between actual cash flows received or paid and those expected
 - ▶ Unrealised gains and losses based on subtracting the remaining cash flows for future period at the end of the period from remaining cash flows for future periods at the beginning of the period
- ▶ **View B – Balance sheet**
 - ▶ Cash receipts/payments should not be taken into account when determining realized gains and losses
 - ▶ Unrealised gains and losses based on the fair value at the beginning of the period, less cash received/plus cash paid less the fair value at the end of the period
- ▶ **View C – Income statement**
 - ▶ The change in unrealised gains and losses based on the fair value at the end of the previous period less the instrument's fair value at the end of the current period
 - ▶ Realised gains and losses are determined based on cash received or paid

Unrealised gain or loss example

Level 3 Derivatives example:

Pay fixed, receive float (specific bank's prime that is not observable) 1 year swap settles quarterly, issued during Q1; transaction price is zero

Fair Value (end of period)	FV by swaptlet				Total	Cash flows:			
	Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4
Fair Value - Q 1	100	100	100		300	0	125	160	250
Fair Value - Q 2		160	150		310		160	250	535
Fair Value - Q 3			200		200			250	535
Fair Value - Q 4					0				535

	Q1	Q2	Q3	Q4	Total
View A					
Unrealized	300	110	50	0	460
Realized	-	25	-	50	75
Total	300	135	50	50	
View B					
Unrealized	300	135	50	50	535
Realized	-	-	-	-	-
Total	300	135	50	50	
View C					
Unrealized	300	10	(110)	(200)	-
Realized	-	125	160	250	535
Total	300	135	50	50	

Summary – Fair Value Disclosures

- ▶ Many entities will need to modify processes, information systems and internal controls
- ▶ Careful assessment of accounting policy options:
 - ▶ Significance
 - ▶ Active market
 - ▶ Using pricing services
 - ▶ Transfers in and out
 - ▶ Unrealised gains/losses
 - ▶ Portfolio valuations
- ▶ Entities who have already adopted the three level hierarchy for fair value disclosures – to determine if disclosures are in line with the amended IFRS 7
- ▶ Effective for annual periods commencing 1 January 2009 – entities need to start preparation now!

IFRS 7 amendments - liquidity disclosures

Required disclosures

- ▶ Undiscounted, contractual maturities for non-derivative financial liabilities (including financial guarantees)
- ▶ For derivatives, contractual maturities required only when essential for understanding the timing of cash flows
- ▶ Otherwise, include in disclosures based on information provided to key management (existing IFRS 7.34(a)), plus how determined, also disclosing if:
 - ▶ Outflows could occur earlier or for different amounts
- ▶ Disclosure of maturity analysis of financial assets held for managing liquidity, if necessary to evaluate an entity's nature and extent of liquidity risk

IFRS 7 amendments - liquidity disclosures (continued)

Contractual maturities to be disclosed in earliest period required to be paid or called for:

- ▶ When counterparty has a choice of when paid e.g. demand deposits,
- ▶ When entity is committed to make amounts available in instalments e.g. undrawn commitments
- ▶ Issued financial guarantee contracts for the maximum amount guaranteed

IFRS 7 amendments - liquidity disclosures (continued)

Disclosures on derivative financial liabilities:

- ▶ Contractual maturities if essential for an understanding of the timing of cash flows:
 - ▶ Interest rate swaps in a cash flow hedge
 - ▶ All loan commitments
- ▶ Undiscounted
- ▶ Disclose net amounts if settled net (e.g. pay floating/ receive fixed interest rate swaps)
- ▶ Gross if gross cash flow exchanged (e.g. currency swaps)

IFRS 7 amendments - liquidity disclosures (continued)

Disclosures on how an entity manages liquidity risk

- ▶ Consider disclosing factors such as:
 - ▶ Committed borrowing facilities
 - ▶ Deposits with central banks
 - ▶ Concentrations of liquidity risk in assets or funding sources
 - ▶ Internal control processes and contingency plans for managing liquidity risk
 - ▶ Instruments with accelerated repayment terms
 - ▶ Instruments requiring posting of collateral
 - ▶ Instruments where mode of settlement is at the entity's choice (cash, another financial asset, own shares etc)
 - ▶ Instruments subject to master netting agreements

Annual improvements to IFRS 7

- ▶ Qualitative disclosures on risks should support and enhance quantitative disclosures
- ▶ Reference to 'materiality' is deleted
- ▶ Credit risk
 - ▶ Maximum exposure to credit risk – disclosure applies only to assets and off balance sheet exposures
 - ▶ Financial effect of collateral and credit enhancements
 - ▶ Remove disclosure relating to instruments renegotiated to avoid becoming past due or impaired
 - ▶ Remove disclosure requirement related to collateral held as security or other credit enhancements
 - ▶ Clarified that disclosure of foreclosed collateral only applies to that held at the reporting date

