

# IFRS News

Shedding light on the IASB's activities\*

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## In this issue...

**1 IAS 19 amendments**  
Implications for  
pension plans

**2 IAS 1**  
Income statement  
presentation

**4 IAS 34**  
2005 interims  
under IFRS

**5 Interview**  
PwC's Sam  
Gutterman

**7 IASB update**  
IASB and IFRIC  
timetables

## IAS 19 amendments

GCRG's actuarial expert Richard Davis looks at the implications of some of the recent amendments to IAS 19, Employee Benefits.

The first article, published in the April 2005 edition of IFRS News, examines the changes to IAS 19 on disclosure and the recognition of gains and losses. This article looks at the changes on pension plans that cover employees of a number of entities.

These plans under IAS 19 fall into three categories:

- Multiple-employer plans (administrative arrangements): these share services, such as pooling investment management and administration, but do not share risks between the participating employers;
- Group plans: these share risks between entities under common control;
- Multiple-employer plans (risk-sharing): these pool contributions from a number of entities that are not under common control to provide benefits to the employees of the participating employers regardless of which employer they work for.

Multiple-employer (administrative arrangements) plans are no different from 'normal' single employer plans. Each participating employer has an identified share in the assets and liabilities of the plan. The contributions that each employer and its employees pay are directly related to the entity's benefit promise and experience. The only element of 'cross subsidy' is the cost saving expected from pooling of service arrangements.

### Multiple-employer plans (risk-sharing)

Multiple-employer plans (risk-sharing) pool risks between entities that are not under common control. They tend to apply to employers in a specific industry or territory. They provide a common scale of benefits and participating employers pay contributions on a standard basis that does not reflect their individual experience.

IAS 19 allows defined contribution accounting for these plans where there is insufficient information available to apply defined benefit accounting. Multiple-employer plans under US GAAP are always accounted for on a defined contribution basis.

The amendments recognise that the economics of multiple-employer plans can differ from those of defined benefit plans. They also emphasise that although defined benefit accounting may be difficult, it does not mean that defined contribution accounting is sufficient. The changes highlight two areas where additional accounting may be required: contractual arrangements regarding the funding and contingent liabilities.

A multiple-employer plan with a contractual agreement that determines the distribution of a deficit's funding between the participating entities requires participants to recognise the liability (or asset) arising from that agreement. Movements in the asset or liability are

recognised as income or expense in the income statement. The funding arrangements for such plans are not revisited every year, and the agreed contribution requirements may look to fund deficits over many years.

#### Example

A new valuation of a multiple-employer plan discloses a deficit; the previous position was in balance. All participating employers are therefore required to pay additional contributions of €1m for the next 20 years.

The new IAS 19 provisions require participating entities to recognise an immediate expense of €13.1m (the present value of the required future contributions). The provision will decrease to €11.8m after three years, reflecting three payments and the unwinding of the discount. The €11.8m will be released through the income statement if a new valuation at that time shows that good investment returns have removed the deficit.

The amendments emphasise that participation in a multiple-employer plan has implications on IAS 37, Provisions, Contingent Liabilities and Contingent Assets. This requires further disclosures regarding the contingent liabilities that

arise in a multiple-employer plan. The entity may face additional liabilities if another participating employer fails to meet its obligations.

#### Group plans

Group plans are single employer plans in a set of consolidated accounts; they are not the same in the separate financial statements of each entity.

A plan that covers entities under common control is not a multiple-employer plan under IAS 19. The changes mean that some entities will not have to apply defined benefit accounting. The standard requires entities to obtain IAS 19 valuations for the plan as a whole; they are required for consolidated group accounts.

A 'contractual agreement or stated policy' for splitting the pension expense, determined for the plan between the participating entities, should form the basis of each entity's accounting. The entity that is the 'legally sponsoring employer' should apply defined benefit accounting for the plan as a whole if there is no agreement or stated policy; it should treat contributions by other employers in the same way as employee contributions. All other participating entities should apply defined contribution

accounting. One entity in a group at least will have to apply defined benefit accounting in addition to the defined benefit accounting in the consolidated group accounts.

The practice in some territories is that one entity establishes the plan and other entities in the group agree to participate. The entity that established the plan is the 'legally sponsoring employer'. This entity, however, will not necessarily bear the majority of the risks and rewards associated with the plan. All participating entities in other territories may be equally responsible and identifying which entity in a group should apply defined benefit accounting is not always clear.

The amendment also introduces additional disclosure requirements for group plans. Transactions with a group plan are related-party transactions. Each entity needs to disclose details about the plan and the basis of the charge that is recognised in their accounts.

The amendment facilitates the measurement of expenses in accounting for group plans. First-time adopters of IFRS, however, will have to make more extensive disclosures than under previous GAAP in the separate financial statements of entities within a group.

## IAS 1

# Income statement presentation

All listed companies in the European Union must report under IFRS from 2005. Any group with international operations, whether listed or not, can benefit from making it easier for its major stakeholders to understand its financial statements. GCRG's Gabor Balazs explains.

Income statement presentation is an essential part of stakeholder communications and IFRS aims to add transparency and comparability to this communication. IAS 1, the standard which deals with the presentation of financial statements, contains broad guidelines on presentation format. The qualitative characteristics for the financial statements in the IFRS framework only represent general guidance.

Stakes are high for companies: broad guidelines offer opportunities to drive their communication based on financial statement presentation. The abuse of this flexibility, however, may do more harm than good in the medium term. Analysts may be confused by presentations of 'results before bad news and things management didn't expect'. Regulators will not endorse such flexibility and will request strict rules to be applied. Restatements may occur and

companies' reputations will be tarnished by such behaviour.

How can companies acquire a useful and transparent presentation of their results?

#### How presentation format can make a difference

Most users look at the income statement first for information on the company's financial performance. The notes may

provide useful additional information but the length and complexity prevent most users from considering them in detail. The income statement presentation could influence the user's decision-making. IAS 1 allows companies to report income statements on a functional (costs of sales, selling, marketing, etc...) or a nature (salaries, rent, depreciation, etc...) basis. The temptation to combine both presentations is high, but will transparency and comparability result from doing so?

Imagine two similar companies: one excludes depreciation from its cost-of-sales figure to derive its gross profit figure, and presents depreciation as a separate line item; the other includes depreciation of production equipment in its cost-of-sales figure to reflect a complete functional presentation. It would seem that the company which mixes function and nature expense categories generates more gross profit. This only reflects a choice of presentation and not the actual performance of the company. The first presentation could create confusion for the user and it would not be comparable between different companies.

### Industry practice: slippery slope

Many companies suggest that analysts require certain disclosures on the face of

the income statement, which are not defined or required under IFRS. 'Earnings before interest, depreciation and amortisation' (EBITDA) is an example which is used in many capital intensive industries.

Many different calculation methods exist. Some companies exclude all amortisation and depreciation from the subtotal; others exclude all significant non-cash charges such as restructurings and impairments. This makes 'EBITDA' a wide category that is non-comparable. Analysts must then make various adjustments to the published EBITDA figures based on information from the notes. Disclosing partial information on the face of the income statement (often without an explanation on its calculation) does not add value for users.

### Transparency

Transparent reporting would result from use of a format similar to the examples in the application guidance to IAS 1. Subtotals and further line items only result in clearer presentation if certain criteria are met (see box below).

### Other common reporting issues

- Use of the 'operating profit' subtotal: many companies disclose 'operating profit' even though IFRS no longer

requires it. If this subtotal is presented, IAS 1 states that all activities are presumed to be part of operations apart from the results of financing activities, equity-accounted investments, discontinued operations and taxation.

- 'Non-recurring' or 'exceptional' results: another commonly-used subtotal is the division of operating profit to 'recurring' and 'non-recurring' portions. Management may wish to make this separation to exclude 'difficult debits' or because the items were treated as 'extraordinary' under local GAAP. These subtotals do not usually help to achieve clear presentation, but may be acceptable if the criteria for a mixed presentation are met (see box below).
- Restructuring: as restructuring provisions are not separate 'functions', it is unlikely that a separate line item can be used in a functional expense presentation.

### Conclusion

The income statement presentation can make a difference between companies even if the underlying results are similar. A company that follows IAS 1 will reduce subjectivity and aid comparability between different entities.

## When is a mixed presentation acceptable?

The mixture of function and nature, and the use of subtotals, are only acceptable when all of the following requirements are met:

- The proposed presentation is not misleading: the income statement presentation should be unbiased. The proposed breakdown should not result in a misleading cost-of-sales figure and overstate gross profit. A potential for bias can exist if the subtotal gets undue prominence over the line items and the subtotals normally required by IFRS;
- The presentation should be applied consistently across all years and the 'rules' should be set out in the accounting policies. An entity that wishes to present a subtotal for non-recurring items should have an accounting policy which describes the classification rules (to avoid the cherry-picking of items to be classified as non-recurring); and
- The breakdown of expenses by nature is presented in the notes to the financial statements, as required by IAS 1.93: the breakdown should be made in a separate note, which could be tied to the total of expenses presented on the face of the income statement.



# 2005 interim reports under IFRS

Many listed groups in Europe are considering the format of their first interim reports since IFRS transition. EU legislation does not require interims in accordance with IFRS in 2005, although some national regulators do. Management therefore has some important choices to make on the basis of preparing such reports. By Peter Hogarth.

## Should the interim report be prepared in line with IAS 34?

IAS 34, Interim Financial Reporting, should be applied if required by local regulation or management elects to publish an interim report in accordance with IFRS (and therefore IFRS 1 because the interim report deals with the period covered by the entity's first IFRS financial statements). Where IAS 34 is not required, management can choose to comply with IAS 34 or to prepare its interim report 'in accordance with the basis of preparation described on page x'.

The decision to not comply with IAS 34 has advantages. For example, management might believe that the entity's accounting policies will change between issuing its interim report and its annual financial statements for 2005.

They might also want to apply standards that are not endorsed for use in the EU but may be by the year-end. Issuing an interim report under IAS 34 and then changing accounting policies would require extensive disclosure under IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors. The policies can be changed more easily if the interim report does not claim compliance with IAS 34.

## What does 'basis of preparation' mean?

An entity may choose to describe in detail how the report has been prepared where the interim report does not comply with IAS 34. This would be a 'basis of preparation' note that sets out the policies that the entity has applied. The entity can avoid the difficulties described below by using the

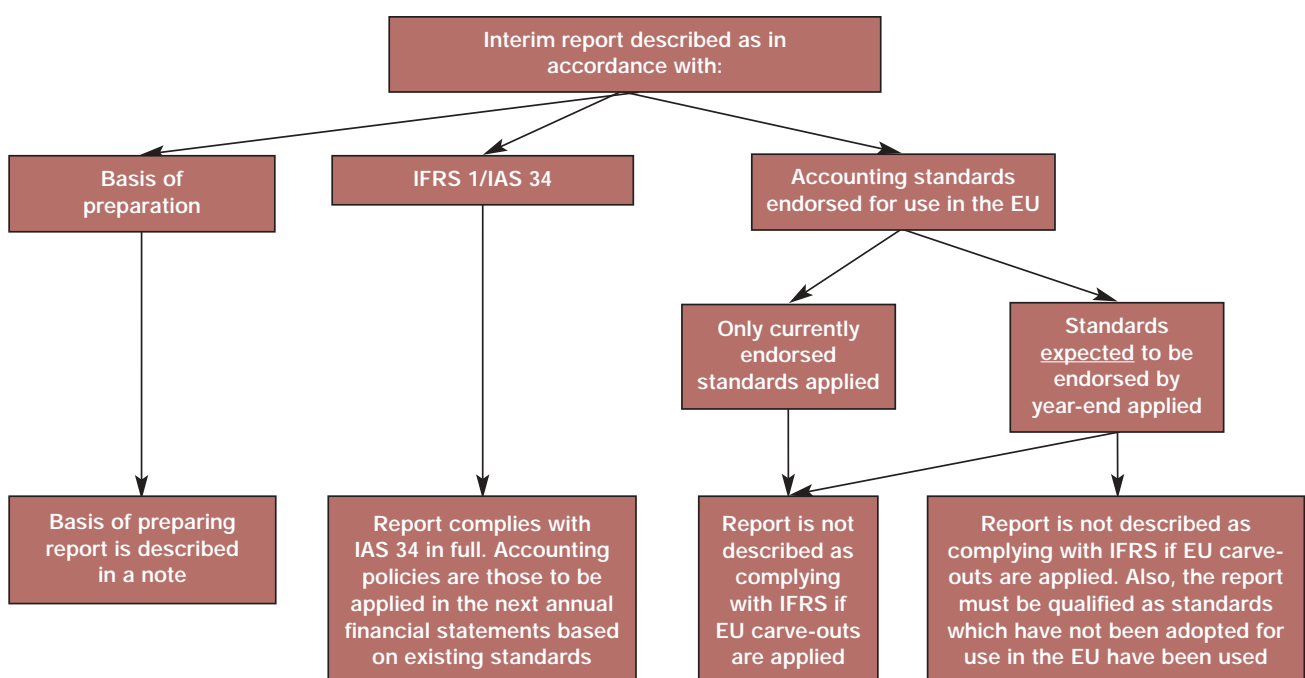
description 'basis of preparation' rather than stating compliance with a particular accounting framework.

## Compliance with standards endorsed for use in the EU

Groups listed in the EU are required to comply with accounting standards endorsed for use in the EU.

The endorsement of IAS 39 in November 2004 with two carve-outs has created a divergence between 'accounting standards endorsed for use in the EU' and IFRS. Other standards issued by the IASB or interpretations issued by IFRIC may also create divergences. There is debate, for example, over the adoption of IFRIC 3, Emission Rights. The endorsement process may also cause a divergence due to different transition dates.

The options available to an EU first-time adopter in 2005 are shown below



How should an interim report be described? The options are to describe the accounting framework as 'IAS 34' or 'accounting standards endorsed for use in the EU'. There are potential pitfalls with both of these approaches.

An interim report described as 'complying with IAS 34' must comply with all of the requirements of IAS 34; the accounting

policies should be those to be applied in the next annual financial statements based on existing standards. The description 'accounting standards endorsed for use in the EU' presents its own problems since only those accounting standards actually endorsed could be used.

EU listed groups may want to prepare their

2005 interims according to a 'basis of preparation' for the reasons mentioned above. This approach gives entities the flexibility to revisit accounting policies for the year-end. It also allows for the possibility that new standards may be endorsed by the EU or issued by the IASB/IFRIC without having to provide the detailed IAS 8 disclosures if changes are made to policies in the annual financial statements.

## Interview



# A fresh look at financial reporting by insurers

PwC Chicago director Sam Gutterman is the representative of the International Actuarial Association on the IASB's Insurance Working Group (IWG). He talks to IFRS News about the group's objectives and agenda.

### What are the IWG's objectives?

Our agenda covers financial reporting of insurance contracts for entities applying IFRS. The IASB has been told that the wide range of current national practice and the lack of transparency in insurers' accounts have resulted in what insurers believe to be undervalued share prices. It should be a high priority to enhance investor confidence in, and understanding of, insurers' financial reporting on an international basis.

The IWG's other objective is to provide advice to the Board regarding the implications of other projects on the Board's agenda to the insurance industry. We will provide input on the financial reporting of liabilities for other contracts offered by insurers and most of their assets. The IASB's Financial Instruments Working Group [see the interview with Pauline Wallace in the May 2005 edition of IFRS News] is discussing both of these

categories. There is likely to be coordination and cooperation between these two working groups.

The IWG's underlying goal is to provide useful advice to the IASB, which aims to release a discussion paper on the financial reporting of insurance contracts in early 2006. If everything goes according to plan, comments received on the discussion paper will be reflected in an exposure draft about a year later.

This project builds on the discussions held by the IASB during its earlier multi-year evaluation of the accounting for insurance contracts. The IASB feels, because of its broader representation, that it is receiving more comprehensive input particularly from preparers and users of insurers' financial statements. The lack of this input was a complaint raised at the time of the previous project.

Board members have attended all of our

discussions, which are open to the public. The IWG is expected to exist until the end of the IASB insurance contracts project.

### What issues have been addressed so far?

The IWG has already had three meetings. There has been extensive discussion on some but not all of the key issues involved. We will present several accounting models to the Board over the next few months for their consideration.

The IASB has indicated that it has few, if any, pre-conceptions regarding the most appropriate accounting treatment of these contracts despite the view from some quarters that the IASB's proposal will be based on fair values.

We are certainly starting the discussions afresh. The IWG's input has so far helped to narrow consideration of the accounting models that will be developed further and

## Biography – Sam Gutterman

- PwC Chicago director responsible for audit support and advisory services for insurance companies and government agencies
- Member of the firm's IFRS Global Insurance Technical Committee
- Chairman of the International Actuarial Association's Committee on insurance accounting
- Sam has written several articles for the North American Actuarial Journal

some of their desirable features. The financial reporting of non-life insurance (covering both contract and claims liabilities) has been the main focus to date, with discussions on life insurance just getting started. We are currently struggling with a preliminary discussion about the implications of an insurer's lack of control over its expected premiums for insurance asset and liability measurement. This is because something

has to be in the control of the entity to qualify as an asset, according to the IASB's framework.

The Board has held educational sessions on non-life insurance in January, February and April this year. Martin White of Equitas and I provided background to the Board in January on common actuarial techniques and current approaches used to estimate

future claims-related cash flows. The Casualty Actuarial Society, the Japanese non-life insurance industry and the Group of North American Insurance Enterprises addressed the implications of discounting and reflecting risk associated with claims liabilities on an explicit basis. The April meeting included presentations from Australian and Canadian IWG representatives on their experience with

## Objectives and membership of the IWG

The IASB announced the membership of its Insurance Working Group in September 2004. The group was set up 'to help [the Board] analyse accounting issues relating to insurance contracts' and assist it in taking 'a fresh look at financial reporting by insurers'.

The IASB's predecessor body, the IASC, produced an 'Issues Paper' and 'Draft Statement of Principles', but other priorities forced the IASB to suspend work on this following its January 2003 meeting. The IASB says it 'will regard the past work as a useful resource but will not feel bound by it'.

Name	Title	Organisation	Country
Phil Arthur	Partner	Ernst & Young	Canada
Norbert Barth	Associate Director, Senior Analyst, Equity Research	DZ Bank AG	Germany
Philip Broadley	CFO	Prudential	UK
Richard Carbone	CFO	Prudential Financial	US
Tony Coleman	Chief Risk Officer and Chief Actuary	Insurance Australia Group	Australia
Denis Duverne	CFO	Axa	France
Sam Gutterman	Chair of Insurance Accounting Committee	International Actuarial Association	International/ US
Rob Jones	Managing Director	Standard & Poor's	UK
Marc Meiches	CFO	GE Insurance Solutions	US
Patrick O'Sullivan	CFO	Zurich Financial Services	Switzerland
Hitesh Patel	Partner	KPMG	UK
Helmut Perlet	CFO	Allianz	Germany
Jörg Schneider	CFO	Munich Re	Germany
Jerry de St Paer	CFO	XL Capital	Bermuda
Joseph Streppel	CFO	Aegon	Netherlands
Mark Swallow	Chief Accounting Officer	Swiss Re	Switzerland
Yoshikazu Takeda	Director and General Manager	Nippon Life	Japan
David Wheat	CFO	ING US Financial Services	US
Hiroyuki Yamaguchi	General Manager	Sompo Japan Insurance	Japan
Alan Zimmerman	Independent security analyst	GA Zimmerman Associates	US

### Observers

- Basel Committee on Banking Supervision
- International Organization of Securities Commissions
- International Association of Insurance Supervisors
- European Financial Reporting Advisory Group

Also participating:

- Staff of the FASB and the Australian Accounting Standards Board

recently introduced systems that incorporate both discounting and risk adjustment.

### What recommendations have the group made?

The IASB is not asking the IWG to make decisions or specific recommendations. It expects the group to provide advice and insight regarding the aspects of insurance business relating to financial

reporting issues that should be considered in the Board's deliberations. For example: revenue recognition, distinction between liabilities and equity, measurement of non-traded liabilities and reporting of comprehensive income.

Discussions and research on these unresolved issues are taking place at the same time as our discussions on their application to insurance.

The Board may discover that decisions which make sense for insurance contracts may not satisfy the needs or current practice of similar situations and issues that arise in other industries. The Board and national standard-setters, whose standards the IASB is attempting to converge with, will attempt to adopt a single set of principles to be followed by all industries that can also work for insurance contracts. A daunting task!

## IASB project timetable

Project	ED published/ expected	Comment deadline	Standard published/ expected
<b>Convergence</b>			
– IAS 37	Quarter 3, 2005	Undecided	Some time in 2006
– Post-employment benefits (not on IASB site)	Undecided	Undecided	Undecided
– IAS 12	After Quarter 2, 2005	Undecided	Undecided
– Amendment to IAS 20	Quarter 2, 2005	Some time in 2005	Some time in 2005
– Disclosures about segments (replacement of IAS 14)	After Quarter 2, 2005	Undecided	Undecided
<b>Business combinations and related issues (FASB and IASB joint project)</b>			
– IFRS 3, Phase 2: application of purchase method	Quarter 3, 2005	Undecided	Some time in 2006
– Minority interests: amendment to IAS 27	Timing expected to match IFRS 3, phase 2		
– Intangibles: amendment to IAS 38	Quarter 2, 2005	Some time in 2005	Some time in 2005
<b>IAS 32</b>			
– Financial Instruments: Disclosures (ED 7)	22 July 2004	22 October 2004	Some time in 2005
– Financial instruments disclosures: shares puttable at fair value	Quarter 3, 2005	Undecided	Undecided
<b>IAS 39</b>			
– Fair value option	21 April 2004	21 July 2004	Quarter 2, 2005
– Amendments to IAS 39, Cash Flow Hedge	8 July 2004	8 October 2004	14 April 2005
<b>Accounting of Forecast Intragroup Transactions</b>			
– Financial guarantee contracts and credit insurance	8 July 2004	8 October 2004	Quarter 2, 2005
– Interest margin hedging	To be decided	To be decided	To be decided
<b>Leases – joint project with UK ASB</b>			
IFRS 4 – phase 2	Some time in 2006	Undecided	Undecided
Consolidation (including SPEs)	Some time in 2006	Undecided	Undecided
<b>Revenue and related liabilities (FASB and IASB joint project)</b>			
Reporting comprehensive income (FASB/IASB/ASB project)	Discussion paper due after Quarter 2, 2005.		
Liabilities and equity	Under deliberation by FASB (see Revenue and related liabilities, above). IASB will add modified joint projects to its agenda when FASB is ready to publish discussion document.		
<b>Standards for Non-Publicly Accountable Entities (formerly: SMEs)</b>			
	Discussion paper issued June 2004; comment deadline 24 September 2004. No ED expected in 2005. Roundtable expected September 2005.		

Note: these dates are provisional only and subject to change

# IFRIC project timetable

Project	ED published	Comment deadline	Final interpretation published/due
D5, Applying IAS 29, Financial Reporting in Hyperinflationary Economies for the First Time	11 March 2004	14 May 2004	Quarter 2, 2005
D9, Employee Benefit Plans with Promised Return on Contributions or Promised Contributions	8 July 2004	21 September 2004	Undecided
D10, Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment	25 November 2004	11 February 2005	Quarter 2, 2005
D11, Changes in Contributions to Employee Share Purchase Plans	16 December 2004	1 March 2005	Undecided
D12, Service Concession Arrangements – Determining the Accounting Model	3 March 2005	3 May 2005	Quarter 3, 2005
D13, Service Concession Arrangements – the Financial Asset Mode	3 March 2005	3 May 2005	Quarter 3, 2005
D14, Service Concession Arrangements – the Intangible Asset Model	3 March 2005	3 May 2005	Quarter 3, 2005
D15, Reassessment of Embedded Derivatives	1 April 2005	31 May 2005	Undecided
Interpretation – Scope of IFRS 2	Draft interpretation approved by IFRIC subject to editorial changes and approval by IASB. Due for release		
IFRIC interpretation – IFRS 2 Share-based Payment: Employee benefit trusts.	Draft interpretation approved by IFRIC subject to editorial changes and IASB approval.		

Note: these dates are provisional only and subject to change

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