



Australian Prudential Regulation Authority

Adoption of International Financial Reporting Standards

Prudential implications

Overview Paper

3 November 2004

1. Introduction

Australian reporting entities will adopt Australian equivalents of International Financial Reporting Standards (IFRS) for reporting periods commencing on or after 1 January 2005.

The introduction of IFRS in Australia will change existing accounting standards in relation to the recognition and measurement of assets, liabilities, equity, revenue and expenses. These changes will impact on APRA's prudential and reporting standards for authorised deposit-taking institutions (ADIs), general insurers, life companies and friendly societies. While Approved Trustees and Superannuation Entities may also be affected, superannuation funds will not be subject to accounting changes on initial adoption of IFRS in Australia.

To assist key decision-makers in APRA-regulated institutions in assessing the implications of IFRS for their entity, this paper provides a qualitative overview of the following:

- interim prudential and statistical reporting arrangements;
- APRA's approach to IFRS;
- key issues arising from adoption of IFRS;
- accounting and prudential implications of each key issue; and
- industry-specific issues arising from IFRS.

Along with prudential regulators around the globe, APRA has been analysing the potential impact of IFRS from a prudential perspective. Moving forward, APRA plans to consult extensively with regulated institutions to better understand the quantitative impact of IFRS. As part of the consultation process, a more comprehensive assessment of specific accounting changes and their prudential implications will be the subject of a series of discussion papers to be released in coming months (see Section 6).

2. Interim prudential and statistical reporting arrangements

APRA has advised regulated institutions that it will not be making any IFRS-related changes to prudential and reporting standards before 1 July 2005 at the earliest. Until further notice from APRA, regulated institutions should continue to report in terms of current requirements. For this purpose, APRA will make appropriate determinations to preserve the use of Australian accounting standards existing as at 31 December 2004, until any changes to the prudential and reporting standards are finalised.

The interim preservation of existing Australian accounting standards is imperative in the case of Tier 1 capital instruments and securitisation requirements. Adoption of IFRS may restrict the range of instruments that qualify as Tier 1 capital for ADIs and general insurers. However, APRA will continue to consider Tier 1 instruments in the context of Australian accounting standards in place as at 31 December 2004. The position outlined in APRA's letter of 5 April 2004, 'Treatment of Tier 1 Capital Instruments', holds until further notice.

Additionally, the clean sale and separation requirements of Prudential Standard APS 120 'Funds Management and Securitisation', Guidance Note AGN 120.3

'Purchase and Supply of Assets (including Securities issued by SPVs) and AGN 120.1 'Disclosure and Separation' will continue to apply on the basis of Australian accounting standards in place as at 31 December 2004. This approach will also apply to any extension of these requirements to general insurers, as envisaged in APRA's Discussion Paper, *Prudential Supervision of General Insurance - Stage 2 Reforms* (November 2003).

3. APRA's approach to IFRS adoption

APRA's objective in its approach to IFRS is to align its prudential and reporting standards with Australian accounting standards and principles to the extent practicable, as the latter provide a widely accepted basis for the recognition and measurement of assets, liabilities and capital.

In certain circumstances, however, APRA's prudential framework will depart from accounting standards. APRA's prudential framework and supervisory approach is forward-looking and primarily risk-based, while accounting standards primarily focus on verification and reporting of past transactions and events. The focus on prospective rather than past outcomes and the fact that risk assessment is a forward-looking concept is an important point of departure from accounting standards. For example, APRA's loan loss provisioning requirements and its valuation methodology for general insurance liabilities are structured on a prospective basis rather than the incurred basis of the accounting standards.

Additionally, APRA's prudential requirements are aimed at protecting the interests of beneficiaries (i.e. depositors and policyholders) even in adverse circumstances, while general purpose financial reporting focuses on evaluating the interests of the economic owners of an institution on a going concern basis. For example, goodwill and identifiable intangible assets are recognised as assets under accounting standards, but not for the determination of regulatory capital under prudential standards. As another example, the adoption of FRS might lead to increased volatility in an institution's reported financial position which, if not adjusted in prudential reporting, might not be representative of the institution's underlying capital strength.

In developing its response to IFRS adoption, APRA intends to take a measured approach to evaluating the financial and prudential implications for regulated industries. This will include consideration of the position of other prudential regulators and concurrent regulatory developments such as general insurance reform and the introduction of the Basel II Framework.

This approach may, for a time, widen the divergence between accounting and regulatory reporting, because APRA will not be making any IFRS-related changes to prudential and reporting standards before 1 July 2005. In the interim, APRA-regulated institutions should continue to comply with, and report in terms of, current prudential and reporting standards. It is APRA's intention to narrow the extent of this divergence over time.

4. Key issues arising from IFRS

IFRS adoption affects many areas of financial reporting. The immediate and ongoing implications are not uniform across APRA-regulated industries and institutions, but depend on such factors as the nature of business activities, balance sheets and capital structures.

For some APRA-regulated institutions, the implications will be less significant, representing mainly a change in the presentation of their financial statements. For others, however, the implications will be more substantive. They may involve changes to the amount and composition of reported financial performance and financial position, to the scope for future capital management, the ability of reporting systems to capture required information and changes to operational and risk management practices.

The key accounting issues arising from the adoption of IFRS and their prudential implications are outlined below. Each institution will need to evaluate which of these issues apply to its situation and assess their impact appropriately. In the coming months, APRA will release four discussion papers to address these issues in more detail.

Classification of equity instruments

AASB 132 'Financial Instruments: Disclosure and Presentation' introduces a stricter definition of equity and, on initial adoption of IFRS, could result in certain preference shares and hybrid instruments currently classified as equity being reclassified as liabilities.

For an instrument to qualify for inclusion in an ADI's Tier 1 capital under APS 111 'Capital Adequacy: Measurement of Capital' and related Guidance Notes, it must (amongst other requirements) be classified as equity under Australian generally accepted accounting principles. GPS 110 'Capital Adequacy for General Insurers' lacks a direct reference to these same principles but the ADI Guidance Notes are used in APRA's consideration of Tier 1 instruments for general insurers. The Guidance Notes are also used in relation to issues of capital instruments by authorised non-operating holding companies.

As a consequence, adoption of IFRS may restrict the range of instruments that qualify as Tier 1 capital for ADIs and general insurers. APRA has previously advised ADIs that it intends to review the treatment of instruments eligible for Tier 1 capital once IFRS changes are finalised. However, until further notice, APRA will be preserving Australian accounting standards in place as at 31 December 2004 in considering Tier 1 instruments.

Capital instruments that have been approved by APRA no later than 31 March 2004, and which may be adversely impacted by the approach adopted post IFRS, will be eligible for any grandfathering and/or transitional arrangements that APRA may put in place in respect of existing issues of instruments included in Tier 1 capital. Instruments approved after 31 March 2004, and which come to be accounted for as debt under IFRS, may cease to be eligible for Tier 1 capital post IFRS. Until the changes are finalised, APRA will only approve instruments which are accounted for as equity under current accounting standards as Tier 1 instruments. Further, future issues arising from multi-issue capital instrument programs approved prior to 31 March will be treated the same as if they had been approved after 31 March 2004.

Derecognition of financial assets and consolidation of special purpose vehicles (SPVs)

AASB 139 'Financial Instruments: Recognition and Measurement' will introduce more stringent requirements on removal from the balance sheet (ie "derecognition") of financial assets sold to securitisation SPVs. This is likely to result in financial assets (such as mortgages) that have been securitised being

brought onto the balance sheet. Transitional arrangements for IFRS provide that assets removed from the balance sheet prior to 1 January 2004 are not required to be brought back onto an entity's balance sheet where they fail the derecognition tests on adoption of AASB 139.

On adoption of IFRS, existing securitisation structures are at risk of failing the clean sale and separation requirements of Prudential Standard APS 120 'Funds Management and Securitisation' and related Guidance Notes, which are linked to the derecognition and consolidation tests in the accounting standards.¹ This would have significant prudential implications for ADIs involved in securitisation activities in terms of future capital management as they may not be entitled to capital relief on loans securitised after 1 January 2004.

ADIs should apply Australian accounting standards in place as at 31 December 2004 to the "clean sale" and "separation" requirements of Prudential Standard APS 120, Guidance Note AGN 120.3 and AGN 120.1. This would also apply to any extension of these requirements to insurers.

Derivative instruments and hedge accounting

Under AASB 139, all derivative instruments will be measured at fair value and be recognised on-balance sheet. This is a departure from the current treatment for derivative instruments that are hedging non-trading positions of ADIs, such as loan portfolios. Measurement of these derivatives will be recognised on-balance sheet instead of off-balance sheet.

AASB 139 also introduces more demanding requirements for derivatives used to hedge risk exposures to qualify for hedge accounting. Hedges that qualify for hedge accounting are likely to be accounted for as either fair value hedges or cash flow hedges. Fair value hedges enable fixed cash flows to be converted to variable cash flows, with gains and losses in the fair value of hedges being reported in profit and loss. Cash flow hedges enable variable cash flows to be converted to fixed cash flows, with gains and losses being reported directly in equity. When a cash flow hedge is terminated (or it fails hedge effectiveness rules), the gains and losses in equity are transferred to profit and loss. The accounting treatment for hedges under IFRS is a significant departure from current accounting practice.

Qualifying for hedge accounting treatment under AASB 139 is important to ADIs which use derivatives to hedge financial assets and liabilities. These include loan portfolios measured at amortised cost, and deposit portfolios. Cash flow hedges which fail to qualify for hedge accounting treatment will expose reported profit and loss to fair value movements of derivatives with no offsetting fair value adjustment for the loan or deposit portfolio being hedged. Accordingly, ADIs may need to make changes to derivative hedging strategies and systems to qualify for hedge accounting treatment. APRA is evaluating the implications of the new hedge accounting treatment for ADIs and the recording of unrealised fair value gains and losses directly in equity. In the interim, APRA will maintain the *status quo* and remove the gains and losses from cash flow hedges from equity and regulatory capital.²

¹ Separation requires that funds management and securitisation schemes stand clearly separate from any ADI involved in the scheme and that there are clear limits governing that involvement.

² This is consistent with advice from the Basel Committee on Banking Supervision. See its 8 June 2004 Media Release 'Regulatory capital in light of forthcoming changes in accounting standards', www.bis.org

Measurement of financial assets and financial liabilities

AASB 139 provides scope for institutions to select specific classifications for financial assets (ie held for trading, held to maturity, available for sale, loans originated) and financial liabilities. Each classification has different accounting rules for measurement and reporting, including fair value or amortised cost. In particular, “available for sale” classification generally requires fair value measurement, with unrealised fair value gains and losses included directly in equity and transferred to profit and loss when realised. For general insurers, life companies and friendly societies, the scope to select the classification and measurement basis is only available for financial assets that are not backing insurance liabilities. Financial assets that are backing insurance liabilities are required to be measured at net realisable market value in most cases (a close approximation to fair value).

This new reporting flexibility has implications for reporting systems and balance sheet and profit and loss reporting. The implications for APRA-regulated industries depend on the extent to which the measurement basis of financial assets and financial liabilities is changed on adoption of AASB 139.

General insurers, life companies and friendly societies currently apply a net realisable market value/fair value measurement framework for almost all financial assets. This is not expected to change materially under AASB 139. For ADIs, some investment securities currently measured at amortised cost may change to fair value measurement but the measurement bases of loan portfolios are not expected to be changed to fair value for financial reporting purposes.

Accordingly, the implications of AASB 139 for prudential and reporting standards are not expected to be significant for APRA-regulated institutions. However, until APRA finalises its prudential and reporting requirements, maintenance of the *status quo* may entail a degree of dual reporting. APRA is currently evaluating the prudential implications of including unrealised fair value gains and losses on financial assets and liabilities in equity.

Capitalisation of acquisition costs

AASB 118 ‘Revenue’ and AASB 139 will limit the costs associated with the acquisition of financial assets, financial liabilities and investment contracts that can be capitalised. This limit will apply to direct incremental costs and may also change the pattern of amortisation of these costs. This is likely to impact on the quantum and timing of profit recognition for investment contracts written by life companies in particular.

Although amended capitalisation rules may have financial implications for general insurers and ADIs, they are not expected to have a prudential impact. Deferred acquisition costs for general insurers are already required to be fully expensed in calculating capital under GPS 110 ‘Capital Adequacy for General Insurers’. Similarly, ADIs are currently required to deduct certain capitalised costs from capital in accordance with APS 111 ‘Capital Adequacy: Measurement of Capital’ and AGN 111.4.

Although the financial reporting implications for life companies (and possibly friendly societies) are significant, the prudential implications are not. Under the current actuarial standards, any implicit acquisition cost recovery is effectively eliminated. An equivalent treatment would be expected to apply to any explicit acquisition cost recovery in the future. APRA will liaise with the Life Insurance

Actuarial Standards Board (LIASB) in considering the detailed implications of IFRS for actuarial standards under the *Life Insurance Act 1995* and for Prudential Rule 35.

Excess of market value over net assets (EMVONA)

The current AASB 1038 'Life Insurance Business' requires all assets of a life company to be recognised at market value, with movements in market value to be recognised in profit and loss. In particular, AASB 1038 requires any excess of the market value of a life company's investment in a life company subsidiary over the identifiable net assets of that subsidiary to be recognised as a separate asset and profit and loss item in the consolidated financial statements of the parent life company, as well as in the consolidated accounts of any ultimate parent company. This item is generally termed EMVONA.

The recognition of EMVONA will be prohibited on adoption of IFRS under the revised AASB 1038 'Life Insurance Contracts' and AASB 138 'Intangibles'. These standards will require consolidated groups that have recognised EMVONA to write it off against retained earnings to the extent it represents internally generated intangible assets. Some EMVONA may be reclassified as an intangible asset, which must then be tested for impairment annually. The financial reporting implications may be material for those consolidated groups that currently recognise EMVONA.

The implications for capital and solvency requirements for life companies are still being evaluated by APRA in liaison with the LIASB. At this stage, the implications are not expected to be material. However, this accounting change may create material prudential capital adjustments for ADIs which own life companies and have recognised EMVONA in their consolidated accounts and prudential reports.

General provisions

Provisions for impairment will be accounted for in accordance with AASB 139, which will replace AASB 1044 'Provisions, Contingent Liabilities and Contingent Assets'. AASB 139 will require provisions for impairment to be recognised on an incurred and incurred-but-not-reported basis. This broadly means that provisions for impairment must be based on loss experience and only recognised after an event on which the loss experience is based has occurred. This is a departure from current practice under which general provisions may be recognised where impairment is considered probable.

AASB 139 also contrasts to APRA's general provisioning model and prescribed provisioning requirements contained in Prudential Standard APS 220 'Credit Quality', which are structured on an expected loss basis. Accordingly, the adoption of IFRS may require ADIs to write back general provisions and some prescribed provisions recognised in accordance with APS 220 in their financial statements. Adoption of AASB 139 may also require modifications to an ADI's reporting processes, notably those on prescribed provisioning, to enable compliance with IFRS general purpose reporting and prudential reporting.

APRA will consult on methods to reconcile the accounting and prudential objectives associated with general provisions. Such provisions have been an important element in the prudential capital regime and the concept of expected loss will remain important in the Basel II Framework. There may be some provisions held by general insurers with respect to premium receivables and reinsurance recoverables that may require review as a result of IFRS changes.

Treatment of defined benefit fund surpluses and deficits by employer sponsor

AASB 119 'Employee Benefits', which will apply for reporting periods beginning on or after 1 January 2006, will require all surpluses and deficits of defined benefit funds to be recognised on the balance sheet of the funds' employer sponsors and movements in this item to be recorded in their profit and loss statement. This is not currently required by Australian accounting standards.

Adoption of AASB 119 may have considerable financial reporting and prudential implications for institutions that are employer sponsors of defined benefit funds which have significant fund deficits. APRA is considering these issues and will consult on the appropriate methods to take them into account.

5. Implications of IFRS for APRA-regulated industries

The implications of IFRS adoption are not uniform across APRA-regulated industries. Outlined below is an overview of issues specific to each industry.

Authorised deposit-taking Institutions

The adoption of IFRS is expected to have the most impact on ADIs. The impact will depend on the extent and nature of business activities, the type of products transacted and capital structure. For ADIs which undertake securitisation activities, transact in derivative financial instruments, are the parent entity of a consolidated life insurance group, have large general provisions, or have preference shares or hybrid capital instruments, the accounting impact is likely to be significant. Where ADIs do not have these activities or features, the financial reporting implications may be largely confined to changes to the disclosure and presentation format of financial statements.

The main accounting changes that APRA expects to be of most interest to ADIs are:

- more restrictive requirements for capital instruments to qualify as equity (AASB 132);
- more stringent rules governing removal of financial assets from the balance sheet and a broader capture of entities that may be required to be consolidated, such as securitisation vehicles (AASB 139);
- recognition of all derivative financial instruments on the balance sheet and measured at fair value. In addition, comprehensive hedge accounting requirements will be introduced (AASB 139);
- prohibition of the recognition of EMVONA of a life insurer's subsidiaries, which is currently permitted under AASB 1038;
- restrictions on the recognition of general provisions (AASB 139);
- change in the measurement basis of financial assets and financial liabilities (AASB 139); and
- recognition of defined benefit fund surpluses and deficits on the balance sheet of employer sponsors (AASB 119).

General insurers

The extent of divergence between the accounting and prudential frameworks is clearly visible in the general insurance sector. General insurers already adopt a different basis of reporting from AASB 1023 'Financial Reporting of General Insurance Activities' for prudential regulatory purposes, so as to be consistent with the prospective liability valuation requirements prescribed by Prudential Standard GPS 210 'Liability Valuation for General Insurers'.

IFRS will introduce changes to the financial reporting of general insurance activities. However, accounting for insurance assets and insurance liabilities will not significantly change from that previously required by AASB 1023, until the International Accounting Standards Board's project on insurance accounting is finalised. This project is not due for completion before 2007.

On adoption of IFRS, the accounting standards of most importance for the financial reporting of general insurers are the amended versions of AASB 1023, AASB 119, AASB 132 and AASB 139. Specific accounting changes introduced by these standards which will be of most interest to general insurers are:

- more restrictive requirements for capital instruments to qualify as equity (AASB132);
- changes in the measurement basis of financial assets and financial liabilities (AASB 139);
- recognition of defined benefit fund surpluses and deficits on the balance sheet of employer sponsors (AASB 119); and
- changes to the capitalisation of policy acquisition costs (i.e. deferred acquisition costs).

Life companies

On adoption of IFRS, life companies will be required to account for insurance contracts and investment contracts differently. The accounting treatment will no longer be contained in one accounting standard but will be governed largely by AASB 118, AASB 132, AASB 139 and a revised AASB 1038.

In September 2004, APRA surveyed life companies and friendly societies to better assess the magnitude of the financial impact of these accounting changes. The survey should be finalised shortly. In the meantime, APRA considers the most material impact on financial reporting will relate to the following changes:

- prohibition on the recognition of EMVONA of a life insurer's subsidiaries, which is currently permitted under AASB 1038;
- change in the accounting treatment of contracts that do not meet the definition of insurance, notably changes to the capitalisation of policy acquisition costs (i.e. deferred acquisition costs);
- changes in the measurement basis of financial assets and financial liabilities (AASB 139); and
- recognition of defined benefit fund surpluses and deficits on the balance sheet of employer sponsors (AASB 119).

In addition, there are two specific issues which should be noted by life companies:

- disallowance of the discounting of tax assets and tax liabilities. AASB 112 'Income Taxes' will prohibit the discounting of deferred tax assets and tax liabilities. This represents a departure from current practice for life companies under AASB 1038. APRA is liaising with the IASB on the prudential implications of this change, including implications for unit pricing in some cases; and
- change in the discount rate to value insurance liabilities. The revised version of AASB 1038 will require the use of a risk-free discount rate to value insurance liabilities where the policy benefit is independent of the performance of those assets backing the insurance liabilities. This is a departure from current practice and may have an impact on the valuation of insurance liabilities, with adverse implications for profit margins for certain lines of business. These could be substantial. APRA and the IASB will review the impact of this change on actuarial standards under the *Life Insurance Act 1995*.

These accounting changes may have considerable implications for financial reporting, with some flow-on changes required to maintain the integrity of the prudential standards. However, further work is required by APRA and the IASB to identify the detailed prudential implications and how best to deal with them. The findings of the recent survey should assist in this regard.

The IASB expects to release a paper later this year outlining the issues associated with adoption of IFRS.

Friendly societies

The accounting implications of IFRS adoption for friendly societies are more wide-ranging than for life companies. In addition to the issues identified above, friendly societies will need to adopt Margin on Service accounting for insurance contracts for general purpose reporting. This need arises because ASIC has advised that the friendly society Class Order 99/1225 applicable for financial years commencing on or before 31 December 2004, will not be extended. This class order exempts friendly societies from certain financial reporting requirements on condition of compliance with the requirements of APRA's Prudential Rule No 47 'Friendly Society Financial Statements'. Accordingly, friendly societies will be subject to the same accounting standards as life companies for financial years commencing on or after 1 January 2005.

APRA and the IASB are currently considering this issue. APRA anticipates that, given the benefit fund structure of friendly societies, a simplified approach to Margin on Services may be able to be used which will comply with the revised AASB 1038. APRA will also be considering the implications of IFRS accounting changes for the prudential reporting requirements for friendly societies.

The IASB expects to release a paper later this year outlining the issues associated with adoption of IFRS.

Superannuation entities

There are no current plans to revise the financial reporting requirements of superannuation funds as part of the initial adoption of IFRS. Superannuation funds are expected to continue to prepare general purpose financial reports in

accordance with AAS 25 'Financial Reporting of Superannuation Plans'. Therefore, APRA does not intend to change its prudential or reporting standards.

At the same time, the adoption of IFRS may have an impact on Approved Trustees and Superannuation Entities. APRA will be monitoring this impact.

6. Consultative approach

APRA will be setting out its proposed approach to dealing with the prudential implications of IFRS in a series of discussion papers that address key IFRS-related issues. The table below is an indicative timetable for release of these discussion papers. APRA will consult fully with interested parties before the proposals are finalised.

Discussion paper reference	Issues	Prudential impact by industry				Period release is expected
		ADIs	GIs	Life	Friendlys	
Fair value ^{3 4}	<i>Derivative instruments and hedge accounting</i>	✓				End 2004
	<i>Measurement of financial assets and financial liabilities</i>	✓	✓	✓	✓	
	<i>Capitalisation of acquisition costs</i>	✓	✓ *	✓	✓	
	<i>Non-accrual loans</i>	✓				
Other prudential issues	<i>Excess of market value over net assets of life insurance subsidiaries</i>	✓		✓		End 2004
	<i>General provisions</i>	✓				
	<i>Treatment of defined benefit fund surpluses and deficits by employer sponsor</i>	✓	✓	✓	✓	
Eligible Tier 1	<i>Classification of equity instruments</i>	✓	✓			First quarter 2005
Securitisation	<i>Derecognition of financial assets and consolidation of special purpose vehicles</i>	✓	✓ *			First quarter 2005

✓ Indicates that industry will be impacted

✓ * Indicates prudential impact will be part of General Insurance Stage II Reforms

³ Disallowance of the discounting of tax assets and tax liabilities to be determined by LIASB

⁴ Change in the discount rate to value insurance liabilities to be determined by LIASB