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Update on Accounting Developments

**– The process to endorse IAS 32, IAS 39 and IFRS 4, and
related supervisory issues**

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Purpose of the note

The purpose of this note is to serve as basis for an exchange of views in the Insurance Committee on:

- The status of the endorsement of the standards IAS 32, IAS 39 and IFRS 4.
- How to organise the work to assess the need for consequential changes to EU and national legislation and regulation following an endorsement of the standards IAS 32, IAS 39 and IFRS 4.

Questions to the Members of the Insurance Committee:

Part 1:

- ***Do Members have comments on the developments concerning the endorsement of IAS 32, IAS 39 and IFRS 4?***

Part 2:

- ***Do Members have comments on the presented procedure for analysing the need for adaptations to EU and national legislation and regulation due to the introduction of IAS 32, IAS 39 and IFRS 4?***

Part 1: Status of the endorsement of IAS 32, IAS 39 and IFRS 4

The status of the endorsement for the different standards is outlined below.

IAS 32

1. IASB adopted the revised version of the standard IAS 32: “Financial Instruments: Disclosure and Presentation” in December 2003. In June 2004, EFRAG¹ published a draft comment letter in which it recommended endorsement of the standard.
2. At the ECOFIN Council 2 June 2004 in Luxembourg, Commissioner Frits Bolkestein proposed to endorse IAS 32, and this was generally supported. The formal opinion by the Accounting Regulatory Committee will probably be delivered at the meeting of 28 September 2004. Adoption by the Commission foreseen for end-November.
3. One much discussed item relating to IAS 32 is the distinction between equity and liabilities for cooperative banks. IFRIC (International Financial Reporting Interpretation Committee) has presented a draft interpretation that responds to the concerns of cooperative banks. If the current draft wording will be maintained in the final interpretation, this would facilitate the endorsement of IAS 32.

IAS 39

4. IASB adopted a significantly revised version of IAS 39: “Financial Instruments: Recognition and Measurement” in December 2003. Further amendments concerning hedging were included in March 2004. The IASB Board has also started further work for future amendments concerning the so-called fair value option, the treatment of credit insurance and financial guarantees, as well as e.g. interest margin hedges.
5. The current endorsement discussions concern the wording of IAS 39 including the March amendments. After long discussions, EFRAG presented a draft comment letter on endorsement in the beginning of June 2004. This letter shows the significant differences in views among accounting specialists on certain provisions, particularly those relating to hedging. Out of the 11 members of the EFRAG Technical Expert Group, 5 support endorsement and 6 are opposed. However, the letter still recommends endorsement, as the EFRAG threshold of 75% of the members against endorsement was not reached. The final EFRAG endorsement advice letter will be issued around 5-6 July 2005.
6. The IASB High Level Group on IAS 39 met on 9 June 2004. The meeting was held in a positive atmosphere, and a number of difficult issues for the banking and insurance industries were discussed. IASB informed that a satisfactory presentational solution for cash flow hedges could be envisaged, and that IASB was committed to study the issue of interest rate margin hedges further. An international working party will be created to assist staff on phase II of the insurance accounting and to look into outstanding issues relating to IAS 39.

¹ EFRAG material can be accessed at the EFRAG website: www.efrag.org

7. The Accounting Regulatory Committee discussed the endorsement of IAS 39 in its meeting on 14 June 2004. The Commission Services initiated a tour de table asking Member States whether they supported full adoption of the standard, full rejection or an intermediate solution where the controversial provisions concerning hedging were suspended. Four Member States declared that they were against endorsement of IAS 39 in its current form, but that they were ready to examine an intermediate solution. Fifteen Member States advocated full endorsement of the standard, and six Member States were not able to give a position. Member States were asked for their written comments before 30 June 2005.
8. In July Commissioner Bolkestein will inform the Commission College of the orientation he intends to propose for IAS 39. A formal opinion of the ARC could be delivered at the earliest on 28 September 2004.

IFRS 4

9. IASB adopted the standard IFRS 4 “Insurance Contracts” in March 2004. The draft standard applies to insurance contracts that an entity holds, not to all contracts issued by an insurance company. It does not apply to other assets and liabilities of an insurer, such as financial assets and liabilities in the scope of IAS 39. The draft standard permits an insurance undertaking to continue with current practices for the valuation of insurance liabilities during phase 1. However, certain practices (for example equalisation provisions) are no longer allowed.
10. On 4 June 2004 EFRAG recommended the endorsement of IFRS 4 in a letter to the Commission (8 TEG members voted in favour, 2 abstained). The EFRAG Insurance Subcommittee had debated the issues involved in great detail, and the views among its members were split between those who favoured and those who opposed endorsement.
11. IFRS 4 will be included in the package of IAS and IFRS standards that will be proposed for endorsement. The ARC will probably be asked for its formal opinion at the meeting on 28 September 2004. Adoption by the Commission towards mid-November.

Part 2: The process to analyse the need for consequential changes to EU and national legislation and regulations due to endorsement of the standards IAS 32, IAS 39 and IFRS 4

Earlier discussions in the IC and the IC Accounting Subcommittee

12. This subject has been discussed at the meeting of the IC on 22 November 2003, as well as at the IC Accounting Subcommittee on 11 September 2003 and 17 May 2004. The Commission Services had prepared a discussion note for this purpose (MARKT 2527/03).
13. Member States are still analysing the impact of the standards IAS 32, IAS 39 and IFRS 4 on their insurance reporting and supervisory rules. Complicating factors are the considerable divergence in the implementation of the Insurance Accounts Directive in Member States, as well as the connection between financial and supervisory reporting. Member States are considering whether they want to expand the scope of application of IAS rules also to annual accounts, which would directly impact the supervisory statements.

General considerations for the potentially needed amendments

14. At the IC meeting in November, the general approach on the issue of follow-up changes was discussed. The discussion can be summarised as follows:
 - There seems to be general consensus that ***changes to the EU financial reporting and supervisory directives for the interim period 2005-2007/2008 should be kept to a minimum.***
 - ***IASB phase 2 and Solvency II*** are likely to lead to major changes. This fact also calls for limited changes due to phase 1.
 - It is a reasonable starting point to ***intend to maintain a status quo for the interim period.*** One problem is however that the current supervisory reporting requirements are close to identical to or significantly derived from current financial reporting rules. In this interim period supervisors may prefer to keep the "old" financial reporting rules, whilst the issuer of such rules may look towards wider application of IAS rules. This solution may however create problems for industry that has to prepare different set of accounts.
 - The fact that a Member State has opted for a stricter use of a "one set of accounts" solution may also affect the amount of amendments that may be necessary. Certain current proposals by the IASB could ***make it more difficult to keep a single set of multipurpose accounts during the interim period.***

Organisation of the impact analysis on EU and national legislation and regulation

15. Consequential changes following the introduction of IAS 32, IAS 39 and IFRS 4 may be needed in financial reporting as well as in prudential rules. The substantial amount of options included in the EU Directives may reduce – but not eliminate – the need for changes at EU level, but adaptations are likely to be needed at national level.

16. In the meeting of the IC Accounting Subgroup on 17 May 2004 it was agreed to avoid double work to the greatest extent possible. The Commission Services therefore intend to make extensive use of the work underway in the CEIOPS pillar III/accounting subgroup concerning the need for adaptation to prudential rules.
17. Concerning the need for adaptations to the financial reporting directives, the Commission may ask the EFRAG Technical Expert Group and the EFRAG Insurance Subcommittee to analyse issues following the introduction of new IAS standards. The CEIOPS accounting group will be welcome to provide advice also on financial reporting issues.

CEIOPS pillar III/accounting subgroup

18. The CEIOPS working group has held two meetings so far. The group is chaired by Alberto Corinti/Fausto Parente.
19. On its own initiative, CEIOPS has included the issue of implications of the use of IAS rules in the draft terms of reference for this group. The first step in this process has already been undertaken with a detailed questionnaire on the application of IAS in Member States. A detailed analysis will be undertaken, and a report will be prepared with a tentative early autumn deadline.

Timing issues and next steps

20. The potential need for adjustment to EU Directives requires timely actions in order to assure consistency between IAS accounting, EU financial reporting rules and prudential rules.
21. The Commission Services, in close cooperation with CEIOPS, will present proposals for needed prudential adjustments as soon as possible considering the endorsement process. If necessary, formal proposals to amend directives should be presented in the autumn. These proposals will take the analysis made in CEIOPS into account.
22. Possible amendments to the Insurance Accounts Directive will be included in an overall project to analyse the need for changes to all financial reporting directives following the endorsement of new IAS. This project will be managed by unit G5 "Accounting and auditing", in close cooperation with the F3/Insurance Unit concerning the insurance issues.
23. A further meeting of the IC Accounting Subcommittee could be foreseen when detailed proposal for amendments has been prepared. Tentative timing: November 2004.
24. The Insurance Committee will be consulted on proposals for amendments to the prudential as well as the financial reporting Directives.

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