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IFRS–US GAAP

Does the Market need Convergence?

Stefan Schuermann

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- ▶ **History of IASB-FASB convergence**
- ▶ Main differences between the two standards today
- ▶ US GAAP reconciliation analysis, 2004/5 reporting years
- ▶ Investors' view of accounting standards
- ▶ Challenges


History of IASB-FASB convergence; six years from “exploration” to “roadmap”...

- ▶ **SEC: Concept release in 2000**
 - To **explore the possibility** of eliminating reconciliations to US GAAP
 - Study of US GAAP difference between IAS/IFRS and other standards

- ▶ **Sarbanes-Oxley 2002**
 - Requires standard-setters to **consider** the issue of **international convergence** of accounting standards for “protection of investors”


- ▶ **Norwalk agreement FASB-IASB, October 2002**
 - “**Commitment to develop** ... comparable accounting standards that could be of use in both domestic and cross-border financial reporting”

- ▶ **FASB–IASB MoU signed September 2006**
 - **Roadmap for convergence** between IFRS and US GAAP between 2006 and 2008

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An established against a “new” system

	US GAAP	IFRS
Philosophy	Rule-based	Principle-driven
▶ Reliability	Not really (fraud...)	Data history too short
▶ Consistency	Yes	Not really in insurance
▶ Comparability	Yes	Improving
▶ Transparency	Yes	Yes, better

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Some main differences today

Issue	US GAAP	IFRS
Revenues (IFRS 4)	FAS 60, 97, 120 classification, FAS 97 are "deposits"	IFRS 4 insurance contract classification
Asset classification (IAS 39)	3 classes Trading, AFS, HTM	4 classes + FVTPL
Real estate in own use (IAS 40)	At cost, less depreciation and impairment; depreciation charged to P&L	At fair value, change in value in equity, depreciation to P&L,
Impairments (IAS 36)	Impairments not reversed	Impairments reversed if increase in fair value due to new event
Foreign currency translation (IAS 39)	All change in FX on AFS securities in equity	Change in FX on AFS securities in P&L; difference fair value to amortised cost in equity
Investments for risks of policyholders (IAS39)	Reported as separate accounts	Included in investments
Deferred tax (IAS 12)	Changes recorded in P&L	Changes in equity

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US GAAP reconciliation: Axa, AEGON, ING, Prudential plc

Local currency, m	2005			2004			2004/5 average
	IFRS	USGAAP	Difference	IFRS	USGAAP	Difference	
Total group des quatre							
Net income	14864	15484	4%	12266	11637	-5%	0%
Shareholder funds	95053	107829	13%	71956	89768	25%	18%

- ▶ Average 2004/5 USGAAP book value 18% higher, net income about the same – what about share price valuation?
- ▶ IFRS Price/Book on average 16% higher, 8% in terms of P/E

→ **Suggests that market does adapt (at least book value view)!**

European peers	Current P/B	2006E P/E	US peers	Current P/B	2006E P/E
Allianz	1.62	10.30	AIG	2.1	11.92
Axa	1.8	12.20	Allstate	1.96	8.26
Aviva	2.28	10.60	Chubb	1.73	9.40
Generali	2.95	16.50	Metlife	1.53	11.54
ING	1.95	10.20	Prudential	1.67	13.70
ZFS	1.76	9.40	St Paul Travelers	1.62	9.12
	2.1	11.5		1.8	10.7
IFRS/USGAAP difference	16%	8%			

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“Group of 4” US GAAP–IFRS reporting differences

- ▶ More volatility when comparison is company by company

Difference in %	Max 2005	Min 2005	Max 2004	Min 2004
Net income	59%	-24%	15%	-82%
Shareholder funds	38%	7%	46%	7%

2005, Change IFRS/USGAAP	Axa	AEGON	ING	Prudential plc
Net income	25%	-24%	-3%	59%
Shareholder funds	7%	19%	13%	38%
Share price performance 2006	7%	0%	10%	20%

- ▶ Improvement in accounting treatment needed!
- ▶ But need for IFRS “inside” adjustments (local rules for liabilities): priority over convergence with US GAAP?!

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Axa, ING, Prudential P&L differences

Impact as % net profits	2005	2004	List not exhaustive
▶ Real estate for own use	-5%	-2%	US GAAP vs IFRS
▶ Debt securities valuation	-2%	0%	
▶ Hedge accounting	6%	5%	
▶ Pension liabilities	-2%	-2%	
▶ DAC & VBA	1%	1%	
▶ Tax treatment	6%	6%	

→ Pensions, real estate valuation, hedge accounting, tax treatment; here convergence would help

Axa, ING, Prudential balance sheet differences

Impact as % shareholder funds	2005	2004	List not exhaustive
▶ Goodwill & purchase accounting	8%	9%	US GAAP vs IFRS
▶ Real estate valuation	-5%	-6%	
▶ Debt securities valuation	-1%	nm	
▶ Derivatives and hedge accounting	1%	0%	
▶ DAC & VBA	2%	1%	
▶ Pension liabilities	3%	5%	
▶ Tax treatment	-2%	2%	

→ Pensions, real estate valuation, tax treatment and purchase accounting

More specific items company by company

Impact as % net profits	2005	2004	
▶ Real estate accounting	-23%	-315%	Prudential
▶ Policy liabilities (with-profits fund)	84%	110%	Prudential
▶ Debt securities valuation	-47%	-116%	Prudential
▶ DAC & VBA treatment	17%	113%	Prudential
▶ Foreign currency translation	95%	-57%	AEGON
▶ Unrealised gains/losses AFS assets	40%	53%	AEGON
▶ Hedge accounting	11%	6%	ING
▶ Loan loss provision estimate, Europe	28%	na	ING
▶ Debt securities valuation	13%	6%	AXA

→ **Local IFRS differences more important than IFRS–US GAAP?!**
(e.g. IFRS application beyond listed companies)

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Convergence roadmap 09/2006 MoU

Some convergence projects	2006	2007	Later
Segment reporting	Q4		
Income tax		Q1 ED	
Business combinations		Standard mid-2007	
Investment properties			Not yet defined
Post-retirement benefits (incl. pensions)			ED 2008 (5-year project)
Investment properties			Not yet defined
Insurance contracts			2008 ED

ED = exposure draft

Source: IASB

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19:55 TOKYO

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Insurance company valuation measures

	KEY “RATIO”	BASIS/DETAILS	IFRS/ US GAAP	EEV
US Investors	Price/Earnings	Net reported earnings	X	
		Normalised or adjusted earnings	X, adj	
		Operating profits	X	
	“ROE”	Return on equity	X	
		Return on economic capital	X, adj	
		Return on embedded value		X
European Investors	Price/EEV	Price to embedded value multiple		X
	NB multiple	New business multiple		X
	Sum-of-the-parts value	Appraisal value (NAV + life in-force + added value non-life + life NB value)		X
		ROE/COC multiple by segment	X	
	Solvency	Solvency I (regulator, rating agency)	X	
		Solvency II (FSA, FTK, SST, US RBC)	X	

Source: Cheuvreux

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IFRS/US GAAP convergence to change investor behaviour?

- ▶ **European** investors use embedded value figure more than IFRS base, although EEV has lost ground in the last 12 months
- ▶ **US** investors have started to recognise embedded value as a valuation tool, but still broadly use ROE and book value measures to value insurance companies
- **Convergence:** could help to focus more on “accounting” and less on (European) embedded value, also depending on further progress on the EEV framework (consistency, comparability)

Source Cheuvreux

M&A: accounting considerations

Date	Acquirer	Aquired	IFRS- IFRS	IFRS- USGAAP	USGAAP-USGAP	Local GAAP
1/2006	Fondiarria SAI	Liguria Assicurazioni	1			
2/2006	Groupama	Basak Sigorta				1
2/2006	AXA AP	MLC Hong Kong	1			
3/2006	Generali	AMB Generali	1			
6/2006	AXA	Winterthur			1	
6/2006	Generali	Toro	1			
7/2006	Eurizon	Banca Fideuram	1			
7/2006	AVIVA	AmerUS group			1	
7/2006	Munich Re	Isviçre Sigorta	1			
9/2006	AXA UK	Thinc Destini	1			
10/2006	AXA	Alpha Insurance	1			
10/2006	Liberty Mutual or Safeco	Winterthur USA				1
11/2006	Aegon	Clark	1			
			9	2		1

Source: Cheuvreux

- M&A transactions: 9x IFRS/IFRS, 2x IFRS/US GAAP (Amer US, Winterthur)
- 2006 M&A list suggests “cross-GAAP” acquisitions exist, but not frequent

Challenges for convergence

► Who needs convergence more, FASB or IASB?

- Financial market attractiveness – US decreasing?
- IFRS adoption by non-European countries: Australia, Hong Kong, China, India, Middle East, etc. → pressure on FASB?

► Too slow?

- Difference in underlying philosophy will take time to convert; convergence timetable might be ambitious
- Many issues are addressed in the short-term plan, but no changes before 1/2009 for IFRS (except voluntary adoption and changes due to amendments to standards)

► US GAAP ruling over IFRS?

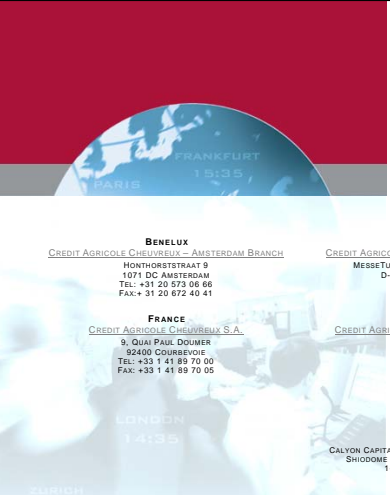
- Rules: easier to look for guidance or resolve disputes (existing literature)?

► Outside influence!

- Pressure from European **Solvency II** developments to go ahead with fair value project, not the same interest at FASB in that regard
- **SEC-CESR** (1. use of IFRS and US GAAP; 2. modernisation of reporting; 3. risk management)
- Diverse local country **tax** regulations
- **Political** influence: European Parliament endorsed IFRS; US Congress influence on SEC

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