



Asset impairments and Insurance: Key issues

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I – General overview of impairment testing under IFRS

II – Impairment process: Description and practical examples from the insurance industry

III – Practical technical issues: A special highlight of the insurance sector

IV – Overview of recent research on asset impairment

What are we talking about?

- All EU-based listed companies should comply with IAS 36
- **Objective** : assets should be carried at no more than their recoverable amount i.e. economic value under IAS 36.
- **Recoverable amount** of an asset or a CGU is the higher of an assets fair value less costs to sell and its value in use.
 - **Fair value less costs to sell (FVLCS)** is the amount obtainable from the sale of an asset or CGU in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal.
 - **Value in use (VIU)** is the present value of future cash flows expected to be derived from an asset or a CGU.

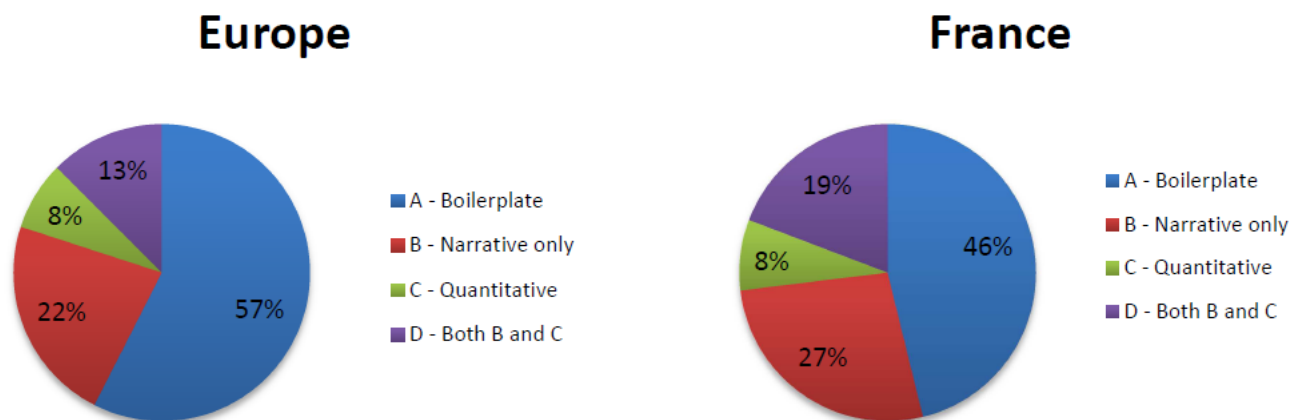
What are we talking about?

- At each balance sheet date an entity should assess whether there is any indication that an asset or a CGU (group of assets) may be impaired.
- If any such indication exists, the entity should estimate the recoverable amount of the asset.
- If no indication exists, no need to make a formal estimate of recoverable amount; except for:
 - Goodwill acquired in business combination
 - Intangible assets with an indefinite useful life
 - Intangible assets not yet available for use
 - Subsequently, any investment in associates

Part I – General overview of impairment testing under IFRS

Where do we stand?

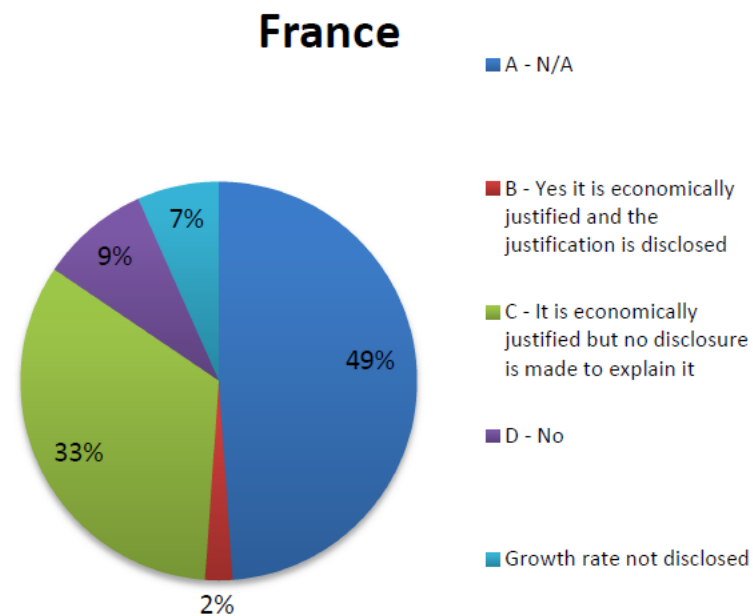
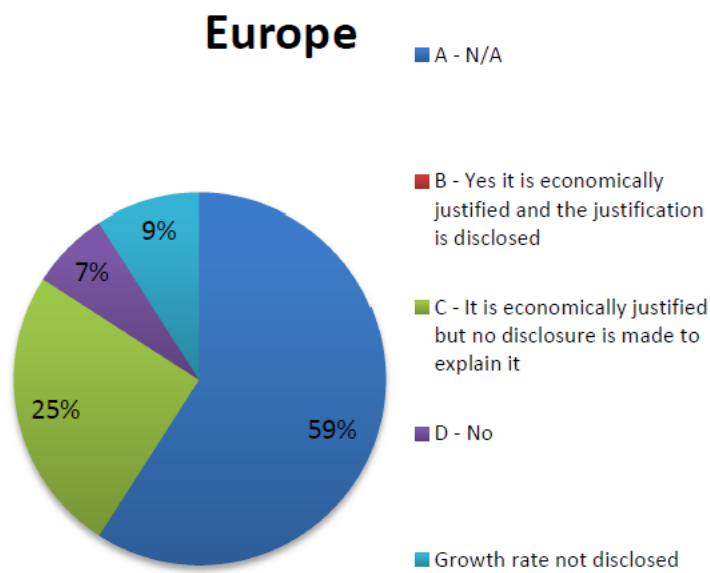
- Many professional and academic studies report discrepancies over IAS 36 implementation (PwC, 2009; AMF, 2013; Paugam and Ramond, 2015)
- Excerpts from the AMF report
 - Statistics about “Hypothesis quality” (sample : top French vs. EU listed firms)



Part I – General overview of impairment testing under IFRS

Why looking into IAS 36 practices appear to be value relevant to actuaries?

- IAS 36 disclosures are informative about insurance companies although practices are still heterogeneous
 - Issues at stake are chiefly related to financial and actuarial assumptions (FV topics) made over insurance-based A/L
- Excerpts from the AMF report (Q. Growth rate used is over 3% p.a.?)



Description of the process: Wrap up

- **Impairment test:**

- “Reality check”
- Are my assets overvalued? Am I overstating shareholders’ equity?

1. **For frequently exchanged (traded) assets:**

- Compare book value of assets in the balance sheet to the most recent (ideally continuous) market price
- Price should always be above book value: Prudence (conservatism)!

2. **For non traded / specific assets:**

- Rely on an estimate: the value of using the assets
- Based on forecasting cash flows associated with the asset
- Estimates should always be above book value

Value in use: Business plan

- **Relevant approach for:**
 - Assets non traded or illiquid (fair value is unavailable)
 - E.g., Investment in associates and joint ventures
 - Available for sale equity investment
 - Goodwill
 - Brand names
- **Value in use** is the present value of future cash flows expected to be derived from an asset. Estimating it involves:
 - Estimating the future cash inflows and outflows to be derived from continuing use of the asset and from its ultimate disposal; and
 - Applying appropriate discount rate to those future cash flows.

Value in use: Business plan

Measurement

- Reasonable and supportable assumptions that reflects management's best estimate
- Most recent financial budgets/forecasts approved by management (excluding future restructurings and improvements to enhance performance) – *subject to managerial discretion*
- Short term projections: 5 years (unless a longer period can be justified)
- Relevant assumptions:
 - Specific for each business segments (e.g., Life & Savings, Property and Casualty, Asset management, Banking)
 - Valuation methods are also specific (DCF, Embedded value)

Examples

Allianz (Annual Report, 2014) – Assumptions (Property and Casualty segment)



Significant assumptions

In determining the business plans, certain key assumptions were made in order to project future earnings.

For entities included in the CGUs of the Property-Casualty business segment, the business plans are mainly based on key assumptions including expense ratio, loss ratio, investment income, risk capital, market share, premium rate changes and taxes. The basis for determining the values assigned to the key assumptions are current market trends and earnings projections.

Examples

Axa (Annual Report, 2014) – Assumptions (Property and casualty segment)



PROPERTY & CASUALTY AND ASSET MANAGEMENT

For each group of units of the Property & Casualty and Asset Management businesses (tested separately), the calculation uses cash flow projections based on business plans approved by management covering up to a five years period and a risk adjusted discount rate. Cash flows beyond that period have been extrapolated using a steady growth rate and terminal value.

Value in use: Parameters of the discount rate

- **Current market assessments of time value of money and risks specific to the asset**
 - WACC of a listed entity that has a single asset (or portfolio of assets) similar to the asset/CGU under review.
- **If not available, then use** following as a starting point:
 - Entity's WACC (using CAPM capital asset pricing model);
 - Entity's incremental borrowing rate;
 - Other market borrowing rates (for similar companies and/or assets);
- **However, these rates must be adjusted to reflect specific risks associated with the projected cash flows.**

Focus on the estimation of beta coefficient

Parameters of the WACC

$$\text{WACC} = (D/V \times R_d) + (E/V \times R_e)$$

where:

D = Debt

E = Equity

V = E + D

R_d = borrowing rate or return on debt

R_e = return on equity

R_e computed with the CAPM:

$$R_e = r_f + \beta \times (r_M - r_f)$$

Allianz 

The discount rate is based on the capital asset pricing model (CAPM) and appropriate eternal growth rates. The assumptions, including the risk free interest rate, market risk premium, segment beta and leverage ratio, used to calculate the discount rates are in general consistent with the parameters used in the Allianz Group's planning and controlling process.

Focus on the estimation of beta coefficient

$$R_e = r_f + \beta \times (r_M - r_f)$$

- Choice of the appropriate Benchmark (EuroStoxx 600, CAC All tradable, etc.)
 - Back to portfolio theory (the “market portfolio”)
- Time window for estimating historical beta one year or five years?
 - In theory, beta is supposed to be time constant!

Example, Axa (May 22, 2015):

Levered beta:

1-Year: 0.99

2-Year: 1.15

3-Year: 1.31

5-Year: 1.56

Examples

Allianz (Annual Report, 2014)



DISCOUNT RATES AND ETERNAL GROWTH RATES FOR THE CGUS IN THE PROPERTY-CASUALTY BUSINESS SEGMENT

%		
CGUS in the Property-Casualty business segment	Discount rate	Eternal growth rate
Insurance German Speaking Countries	7.8	1.0
Insurance Western & Southern Europe	8.1	1.0
Insurance Iberia & Latin America	16.5	4.0
Asia-Pacific and Middle East	10.8	3.0
Central and Eastern Europe	9.3	1.5
Global Insurance Lines & Anglo Markets	9.0	1.5
Specialty Lines I	8.0	1.0
Specialty Lines II	8.0	1.0

Examples

Allianz (Annual Report, 2014)



37 – Impairments of investments (net)

IMPAIRMENTS OF INVESTMENTS (NET)

€ MN	2014	2013
IMPAIRMENTS		
Available-for-sale investments		
Equity securities	(553)	(391)
Debt securities	(345)	(56)
Subtotal	(898)	(448)
Investments in associates and joint ventures	–	(108)
Real estate held for investment	(24)	(54)
Loans and advances to banks and customers	(16)	(24)
Non-current assets classified as held for sale	(5)	(31)
Subtotal	(944)	(665)

Examples

Axa (Annual Report, 2014)



COMMON KEY ASSUMPTIONS TO ALL SEGMENTS

In these tests, for all segments, discount rates used in non-risk neutral approaches range from 6.0% to 10.8%, compared to range from 5.6% to 11.9% in 2013, and growth rates, where applicable, from 2% to 4% beyond the strategic plan horizon, which corresponds to the same growth rates as in 2013.

Importance of impairment: Auditor's report

Axa (Annual Report, 2014)



II - JUSTIFICATION OF OUR ASSESSMENTS

In accordance with the requirements of Article L.823-9 of the French Commercial Code (*Code de commerce*) relating to the justification of our assessments, we bring to your attention the following matters:

- the carrying value of goodwill is tested for impairment at each closing date using the methods described in Notes 1.7.1 and 5.2.2 to the consolidated financial statements.

We ensured that the valuation approaches used were based on assumptions that are consistent with the forecasts resulting from the strategic plans established by the Group. We also examined the information gathered by the Group to justify the other assumptions used as well as the sensitivity tests performed;


The Statutory Auditors

*French original signed by **

PricewaterhouseCoopers Audit
Michel Laforce – Xavier Crépon

Mazars
Philippe Castagnac – Gilles Magnan

Topical issues at stake



- Testing for impairment at the end of each reporting period: why I/S matters?
- Is market capitalisation a good impairment indicator?
- What is an appropriate discount rate for VIU?
- Goodwill allocation and specific disclosures: what and why?

Impairment testing and I/S at closing

- Testing for impairment at the end of each reporting period
 - IAS 36 allows the impairment test to be performed at any time during the period
 - provided it is performed at the same time every year.
 - Different CGUs or groups of CGUs may be tested for impairment at different times.
 - requires efficient, real-time and interactive I/S
 - Many entities test goodwill at an interim period in the year.
 - Especially over unstable times with high uncertainty
 - What if indicators of impairment arise after the annual test has been performed?

A special impairment indicator: market capitalisation

- Undertaking of an impairment test if there are indications of impairment.
 - How identifying key performance indicators of impairment?
- Internal and external indicators of impairment (non-exhaustively) listed up by IAS 36.
 - The carrying amount of the net assets of the entity exceeds its market capitalisation.
- What an entity has to do in response to this indicator is contingent to the firm's environment.
 - Any entity should test goodwill for impairment unless there was sufficient headroom in a previous impairment calculation
 - Some assets or CGUs may or may not be sensitive to market capitalisation as an indicator.

Computation of parameters of the discount rate

- What is an appropriate discount rate?
- Not much guided : *“the discount rate is supposed to appropriately reflect the current market assessment of the time value of money and the risks specific to the asset or CGU”*.
- Unlike the cash flows used in an impairment test that are entity specific
- The appropriate way to calculate the WACC is a complex subject (much academic literature, no general consensus).
- Objective: obtaining a rate which is robust and testable.
 - Pre-tax vs. post-tax rate? Still under scrutiny...

Goodwill impairment disclosures

- Under IAS 36, acquired goodwill should be allocated to each of the CGUs, or to a group of CGUs, that are expected to benefit from the BC synergies.
- IAS 36 requires extensive disclosures about goodwill
 - by CGU or group of CGUs, if the amount of goodwill allocated to a CGU, or group of CGUs, is significant in comparison with the total goodwill.
 - Disclosure includes the carrying amount of goodwill, management's valuation approach —VIU or FVLCS— and the related key assumptions and robustness checks.
 - What if some or all of the carrying amount of goodwill is allocated across various CGUs, or groups of CGUs resulting in a loss of significance of the total amount allocated?



Some of our recent empirical work:

- Paugam and Ramond (2015) – economic consequences of impairment-testing disclosures
- André, Filip and Paugam (2015) – macroeconomic effects of impairment recognition/avoidance under IFRS
- Filip, Jeanjean and Paugam (2015) – How managers manipulate the outcome of impairment tests?

Paugam and Ramond (2015): Consequences of disclosures

Index based on Impairment-testing disclosures (IAS 36):

- Procedures to ensure that assets (or CGU) are carried at no more than their recoverable amounts (highest amount between value in use and fair value less costs to sell)
- Valuation hypotheses and process
- Expected future cash flows
- Discount rates for each CGU and parameters
- Risk free rate
- Tangible and intangible assets (including goodwill)

Paugam and Ramond (2015): Consequences of disclosures

Main results (French sample):

- Negative association between cost of capital and general impairment-testing disclosures;
- distinguishing between prospective and descriptive information disclosed, we find out that only the first set of information drives this negative relationship;
- Firms that avoid economic impairment exhibit no association between cost of equity and disclosures
 - Those disclosures are perceived as not credible

The issue of timely impairment recognition

For managers:

- On average, impairment is a negative signal to market participants: harm reputation (admit a mistake), associated with failed acquisitions, lower CEO compensation, debt contracts violation...

For investors:

- “Goodwill write-offs, if done in a timely manner, are of interests in terms of the signal they send about the value of the company’s intangible assets, the company’s future earnings prospects, and an assessment of the amount paid for acquisitions”
CFA Institute Magazine (May 2014)

Big Picture

- (Conditional) Conservatism: accountant's tendency to require a higher degree of verification when recognizing **good news** than when recognizing **bad news**
- Conservatism is an important metric of **accounting quality**: contracting / litigation / income tax / regulatory explanations
- Introduction of impairment tests for goodwill to **better reflect its economic nature**
- **Impairment tests** are considered the main mechanism ensuring conditional conservatism

In particular impairment of **goodwill**, i.e., after a merger or an acquisition, the excess price paid over the net fair value of acquired assets

André, Filip and Paugam (2015): Impairment – macroeconomic effects

- The mandatory IFRS adoption was associated with a move from **rules-based** accounting systems to a **principle** based approach (except UK and IRL)
- The effect of the adoption of IFRS on conservatism is *a priori* unclear
- IFRS are **less prudent?**
 - The term prudence has been removed from the conceptual framework
 - IFRS allow various fair value options
- IFRS are **more prudent?**
 - Recognition of probable liabilities vs. non-recognition of contingent assets
 - Lower of cost or net realizable values for inventories
 - More strict impairment rules for financial assets and long-lived assets

André, Filip and Paugam (2015): Impairment – macroeconomic effects

- Conservatism has actually **decreased** after the mandatory adoption of IFRS on Europe
- **Why** has conservatism decreased ?
 - Is it the standards *per se* or the way the standards are **enforced**?
 - Inappropriate **enforcement** of impairment tests has increased the possibilities to manage earnings and is a potential explanation
- We show that firms **booking a goodwill impairment** (“good guys”) present a **smaller decline** in the degree of conditional conservatism relative to firms that do not (“bad guys”)
- Impairments tend to be **manipulated**: delayed impairments reduce the level of conservatism

Part IV – Overview of recent research studies on asset impairments

André, Filip and Paugam (2015): Impairment – macroeconomic effect

- The current impairment regime better reflect the economics of goodwill but potentially generates costs (real activity management)
- How to design a system allowing to enforce impairment testing rules?
- Better monitoring of valuation assumptions by auditors gives an incentives to manipulate more real activities
- The problem is likely to be more and more important in the future (goodwill accumulates)

Part IV – Overview of recent research studies on asset impairments

Filip, Jeanjean and Paugam (2015) – manipulation of impairment tests

- Booking a goodwill impairment is **acknowledging bad investment decisions**, therefore firms tend to delay the recognition of goodwill impairment
- **How** managers convince various gatekeepers that recognizing an impairment loss is unnecessary although it seems economically justified?

SFAS 142 requires managers to **forecast future cash flows** to justify the decision to recognize or not an impairment loss

We show that US firms delay impairment recognition by **manipulating upward current cash flows** (although this is detrimental to **future performance**)



Thank you!

