EXPOSURE DRAFT 2015/11

APPLYING IFRS 9 FINANCIAL INSTRUMENTS WITH IFRS 4 INSURANCE CONTRACTS

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2015/17

Summary

On 9 December 2015, the International Accounting and Standards Board (IASB) published Exposure Draft 2015/11 Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts* (the ED).

This ED contains proposed amendments to IFRS 4 *Insurance Contracts* and is designed to address the concerns about the effects of different effective dates of IFRS 9 *Financial Instruments* and the forthcoming new insurance contracts Standard.

The International Accounting Standards Board (IASB) issued the completed version of IFRS 9 in July 2014 and is at advanced stage in its project to replace IFRS 4. However, it is expected to allow an implementation period of approximately three years after the publication of the new insurance contracts Standard. Hence, the earliest possible mandatory effective date of the new insurance contracts Standard will be after the effective date of IFRS 9 (1 January 2018).

Some interested parties, mainly insurers and their representative bodies, have suggested that the IASB should permit insurers to defer the application of IFRS 9 in order to align the effective date of that Standard with the effective date of the new insurance contracts Standard. They give the following reasons to support this approach:

(a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before the new insurance contracts Standard.
(b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated.
(c) Two sets of major accounting changes in a short period of time could result in significant cost and effort for both users and preparers of financial statements.

As a consequence of the above, the IASB proposes to introduce:

(a) an option that would address additional accounting mismatches and temporary volatility by permitting entities that issue contracts within the scope of IFRS 4 to reclassify, from profit or loss to other comprehensive income, some of the income and expenses arising from designated financial assets (the 'overlay approach'); and
(b) an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4. This temporary exemption is targeted at entities that are most affected by the different effective dates of IFRS 9 and the new insurance contracts Standard, because they engage mainly in activities that result in contracts within the scope of IFRS 4.

The proposed changes are open for comment until 8 February 2016. The 60 day comment period is shorter than the usual 120 days, because the proposed amendments are narrow in scope and are urgent.

STATUS

Exposure Draft

EFFECTIVE DATE

For the temporary exemption: annual reporting periods beginning on or after 1 January 2018

For the overlay approach: when the entity first applies IFRS 9 *Financial Instruments*

ACCOUNTING IMPACT

May be significant

Background

As a result of concerns raised about the effects of different effective dates of IFRS 9 *Financial Instruments* and the new insurance Standard, IASB members and staff conducted a series of outreach meetings and calls with interested parties including insurers and their representative bodies and with users of financial statements. After evaluating the feedback from these meetings the IASB decided to explore ways of addressing the concerns expressed.

The IASB noted that IFRS 9 introduces significant improvements in accounting for financial instruments that the IASB believes should be implemented on a timely basis. These improvements are particularly important for entities that issue insurance contracts, because they hold significant investments in financial instruments. The improvements introduced by IFRS 9 include:

- (a) the new, more forward looking expected credit loss impairment requirements and related disclosures requirements, which will better portray the credit quality of financial assets and provide better information about credit risk and how that risk is managed;
- (b) classification and measurement requirements that will better portray how entities manage their financial assets; and
- (c) an improved hedge accounting model and associated disclosures about risk management.

Rather than proposing a temporary exemption from applying IFRS 9 for all insurers the ED proposes the following:

- (a) the introduction of an option for entities that issue contracts within the scope of IFRS 4 *Insurance Contracts* to reclassify from profit or loss to other comprehensive income some of the income or expenses arising from designated financial assets (the 'overlay approach'); and
- (b) an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4.

Proposed amendments to IFRS 4 Insurance Contracts to address the concerns – a summary

Overlay approach

The IASB noted that additional accounting mismatches and temporary volatility that may arise when an entity applying IFRS 4 applies IFRS 9 could be addressed by amending IFRS 4 to permit entities to adjust pre-tax profit or loss to offset the effect of newly measuring certain financial assets at Fair Value through Profit or Loss (FVPL) in their entirety.

The IASB noted that such an approach:

- a) would ensure that the significant improvements in accounting for financial instruments introduced by IFRS 9 would be implemented on a timely basis
- b) would provide information about financial instruments that is comparable with the information that is provided by other entities that apply IFRS 9 *Financial Instruments*
- c) ensures that all financial instruments within a reporting entity are consistently accounted for applying IFRS 9 *Financial Instruments*
- d) would be effective in reducing accounting mismatches for participating and non-participating contracts and would eliminate the additional volatility in pre-tax profit or loss that may arise from applying IFRS 9
- e) would provide additional information to users of financial statements that would help them to understand the effects of IFRS 9, instead of resulting in less information being provided, as would be the case for a temporary exemption from applying IFRS 9.

The IASB concluded that the advantages of the overlay approach for users of financial statements would outweigh any potential costs associated with the required operational change.

Temporary exemption from applying IFRS 9 for insurers

Although the overlay approach addresses the concerns raised about additional accounting mismatches and temporary volatility, it does not:

- (a) avoid the problems associated with insurers having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated; or
- (b) avoid the need for insurers to apply two sets of major accounting changes in a short period of time.

Therefore some interested parties have suggested that the IASB should permit insurers to defer the application of IFRS 9 because such an approach would address most of the concerns raised.

However, the IASB noted that there are disadvantages to providing insurers with a temporary exemption from applying IFRS 9. Such an approach would:

- (a) delay the application of IFRS 9 by insurers; and
- (b) create a different set of added costs and complexities for both preparers and users of financial statements by reducing comparability. This lack of comparability would need to be mitigated by enhanced disclosures.

The IASB concluded that for most entities the disadvantages of a temporary exemption would in most cases outweigh the advantages. However, the IASB noted also that for a small population of insurers (those whose predominant activity is issuing contracts within the scope of IFRS 4) the disadvantages of a temporary exemption from applying IFRS 9 would be less significant because the affected financial assets would represent a more significant proportion of the entity's assets. By limiting the temporary exemption to a relatively small population of entities the problem of reduced comparability for users of financial statements would be reduced.

The overlay approach

In developing this approach, the IASB discussed:

- (a) which assets would be eligible for the approach
- (b) changes in eligibility and re-designation of financial assets
- (c) initial application of, and ceasing to apply, the overlay approach
- (d) transition
- (e) presentation
- (f) disclosures
- (g) operational implications

Eligibility for the overlay approach

The ED proposes that financial assets that meet both of the following criteria would qualify for that approach:

- (a) financial assets that are classified at FVPL in their entirety applying IFRS 9 but that would not have been so measured applying IAS 39 *Financial Instruments: Recognition and Measurement*
- (b) financial assets that are designated as relating to contracts that are within the scope of IFRS 4.

Changes in eligibility and re-designation of financial assets

Consistently with IASB's objective the ED proposes that:

- (a) an entity can elect to apply the overlay approach on a prospective basis to new or existing financial assets when the qualifying criteria for the overlay approach are met; and
- (b) the overlay approach should not be applied to any financial assets for which the qualifying criteria are no longer met.

To address concerns about the potential for entities to change the designation of their financial assets to achieve a particular accounting outcome, the ED proposes that entities should be permitted to change the designation of a financial asset only if there is a change in the relationship between the financial asset and the contracts within the scope of IFRS 4.

Initial application of, and ceasing to apply, the overlay approach

The ED proposes that:

(a) an entity would be permitted to apply the overlay approach before the mandatory effective date of IFRS 9 *Financial Instruments* if it chooses to apply IFRS 9 early
(b) an entity that has already applied IFRS 9 without applying the overlay approach would not be permitted to start applying the overlay approach
(c) the overlay approach will no longer be permitted when a reporting entity first applies the new insurance contracts Standard.

Transition

The ED proposes that when an entity first applies the overlay approach to its financial assets the approach to transition and comparatives for the overlay approach should be consistent with the approach to transition and comparatives taken in IFRS 9.

IFRS 9 requires entities to apply that Standard retrospectively, subject to some transition reliefs. However, in the year of adoption an entity is permitted but not required to restate comparative information.

Presentation under the overlay approach

The ED proposes that entities that apply the overlay approach should present the amount reclassified from profit or loss to Other Comprehensive Income (OCI) as a separate line item in the statement of profit or loss, OCI or both. This should enable users of financial statements to calculate what profit or loss before tax would have been without the overlay adjustment and consequently enable them to compare profit or loss before tax on a consistent basis regardless of whether an entity applies the overlay approach.

Disclosures

To enable comparisons the ED proposes disclosures that enable users of the financial statements clearly to understand the effect of the overlay approach on the financial statements. To address the concerns expressed by some interested parties that changes in designation of financial assets could be used to manipulate reported profit, the ED also proposes specific disclosure requirements for changes in designation of financial assets.

Operational implications

The IASB acknowledges that applying the overlay approach would be more costly than applying only IFRS 9 *Financial Instruments*. However:

(a) the IASB proposes that the overlay approach should be optional; and
(b) the overlay approach would only apply if the entity was already measuring the financial assets applying IAS 39 other than at FVPL in their entirety.

Temporary exemption from applying IFRS 9 Financial Instruments for some insurers

As noted above, the IASB has decided not to propose a temporary optional exemption from applying IFRS 9 for all insurers. Instead, it has proposed a temporary exemption only for entities that are affected by the different effective dates of IFRS 9 and the new insurance contracts Standard when their predominant activity is to issue contracts within the scope of IFRS 4.

The IASB identified two ways in which eligibility for the temporary exemption from applying IFRS 9 could be assessed:

(a) assessment at the reporting entity level: under this alternative an entity would assess whether the entity (typically a consolidated group) as a whole qualifies for the temporary exemption;
(b) assessment below the reporting level: under this alternative a reporting entity would assess whether it qualifies for the temporary exemption below the reporting entity level (a subsidiary level assessment).

The ED proposes that entities should assess whether they are eligible for the temporary exemption at the reporting entity level rather than below the reporting entity level. This is because assessment at the reporting entity level:

(a) is easier for users to understand
(b) captures a relatively narrow population of entities; and
(c) is simple for preparers to apply and users to understand.

Hence, the ED proposes that the temporary exemption from applying IFRS 9 should only be available to entities whose predominant activity is issuing contracts within the scope of IFRS 4. As a result:

(a) entities that issue contracts within the scope of IFRS 4 *Insurance Contracts* but for which this activity is not predominant would not qualify for the temporary exemption
(b) although some financial instruments that relate to non-insurance activities will inevitably be included within the scope of the temporary exemption, such financial assets are minimised.

In developing the proposed temporary exemption the IASB discussed:

(a) how to describe predominance
(b) initial assessment and reassessment of predominance
(c) disclosure
(d) transition
(e) whether to set an expiry date for the temporary exemption.

Describing predominance

The ED proposes that an entity would determine whether its predominant activity is issuing contracts within the scope of IFRS 4 by comparing the carrying amount of its liabilities arising from contracts within the scope of IFRS 4 with the total carrying amount of its liabilities (including any liabilities arising from contracts within the scope of IFRS 4).

The IASB noted that specifying a particular quantitative threshold for when insurance activities would be considered predominant would be arbitrary. Consequently, the ED does not propose a quantitative threshold. However, the IASB has noted in its Basis for Conclusions that the temporary exemption is targeted at the entities that are most significantly affected by the different effective dates of IFRS 9 and the new insurance contracts Standard. Accordingly, 'predominance' is intended to be a high threshold. For example, if three-quarters of an entity's liabilities are liabilities arising from contracts within the scope of IFRS 4 and one-quarter are liabilities arising from other activities, that entity would not, for the purposes of the ED, meet the predominance condition.

Initial assessment and reassessment of predominance

The ED proposes that an entity should determine whether its predominant activity is issuing contracts within the scope of IFRS 4 at the point at which it would otherwise be required to initially apply IFRS 9 (at the beginning of the first annual reporting period beginning on or after 1 January 2018). This reflects the IASB's view that an entity's previous activities or future intentions are not relevant for determining eligibility for the temporary exemption from applying IFRS 9 *Financial Instruments*.

The ED also proposes that an entity should be required to reassess at the end of its subsequent annual reporting periods whether its predominant activity is issuing contracts within the scope of IFRS 4 only if there has been a demonstrable change in the structure of the entity (for example, the acquisition or disposal of a business). If a reassessment following a change in structure indicates that the predominance condition is no longer met, the entity would be required to apply IFRS 9 from the beginning of the next annual reporting period.

Disclosure

The ED proposes disclosure requirements that would enable users of financial statements to make comparisons between entities that apply the temporary exemption and other entities. These disclosures are similar to some of the disclosures required to be provided by entities applying IFRS 9, but primarily rely on an assessment of the contractual terms of the financial assets.

Transition

The IASB considers that an entity that has already applied IFRS 9 (other than only the 'own credit' requirements), should not be permitted to stop applying IFRS 9 and start applying IAS 39.

Consequently, the ED proposes that an entity:

(a) should be permitted to start applying the temporary exemption from applying IFRS 9 only at the time it would otherwise have been required to start applying IFRS 9; *and*

(b) should not be permitted to stop applying IFRS 9 and revert to applying IAS 39.

The IASB noted that when an entity first applies the temporary exemption, no special transition provisions are needed. On the other hand, an entity that applies the temporary exemption should be permitted to stop doing so and start applying IFRS 9 from the beginning of any annual reporting period.

Expiry date for the temporary exemption

The ED proposes that entities should be prohibited from applying the temporary exemption from applying IFRS 9 *Financial Instruments* for annual reporting periods beginning on or after 1 January 2021. The IASB believes that, even if the new insurance contracts Standard is not effective by that date, all entities should be required to apply IFRS 9 by that date.

Should the overlay approach and the temporary exemption from applying IFRS 9 Financial Instruments be optional?

Although the most users of financial statements that participated in the outreach conducted by the IASB stated that any approach proposed to address the concerns about applying IFRS 9 *Financial Instruments* before the new insurance contracts Standard should be mandatory rather than optional, the ED proposes that both the overlay approach and the temporary exemption should be optional rather than mandatory.

First time adopters of IFRS

The ED proposes that first-time adopters of IFRS should be prohibited from applying the overlay approach and the temporary exemption.

The reasons are the following:

(a) such an approach is consistent with the concepts underlying IFRS 1 *First-time Adoption of International Financial Reporting Standards*

(b) first-time adopters could avoid any additional accounting mismatches or temporary volatility by adopting the new insurance contracts Standard early or by adopting accounting policies that are consistent with the new insurance contracts Standard; and

(c) the overlay approach and the temporary exemption from applying IFRS 9 are intended to address concerns raised about the temporary accounting consequences that could arise when an entity makes the transition from IAS 39 to IFRS 9 on a different date from when the entity first applies the new insurance contracts Standard.

Effective dates

For the overlay approach:

An entity would be permitted to apply the amendments when it first applies IFRS 9.Comparative information would only be restated if comparatives were restated in accordance with IFRS 9.

For the temporary exemption:

The date of initial application would be the beginning of the first annual reporting period beginning on or after 1 January 2018. Certain disclosures about credit risk exposures that are required by IFRS 9 would need to be made.

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