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Insurance Accounting Alert

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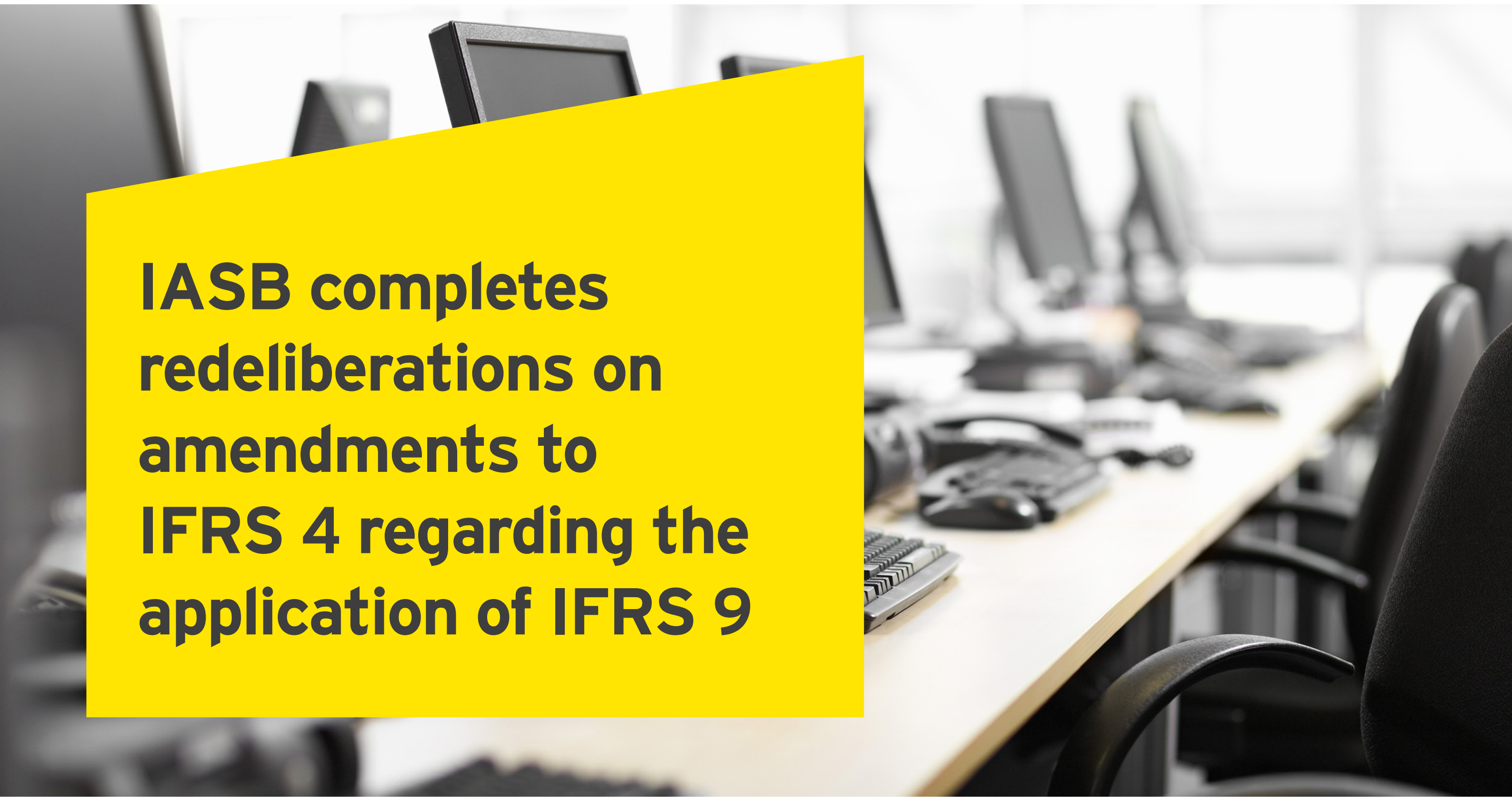

IASB completes redeliberations on amendments to IFRS 4 regarding the application of IFRS 9

What you need to know

The IASB completed its redeliberations on the proposals in the December 2015 Exposure Draft Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts* (Amendments to IFRS 4) (the ED) on the temporary exemption from applying IFRS 9[1] and the overlay approach[2]:

- An entity that is eligible for the temporary exemption from applying IFRS 9 will be required to reassess eligibility if, and only if, there has been a demonstrable change in its corporate structure that could result in a change in predominant activities from being "insurance related".
- An entity that was not previously eligible for the temporary exemption should be permitted to reassess its eligibility if, and only if, there has been a demonstrable change in corporate structure that could result in a change in predominant activities before the mandatory effective date of IFRS 9.
- Where an investor applies the temporary exemption from IFRS 9 but its associates or joint ventures do not (or vice versa), there will be relief from the requirement in IAS 28 to use uniform accounting policies when applying the equity method to account for interests in associates and joint ventures.
- First-time adopters will now be allowed to apply the temporary exemption where they meet the qualifying criteria, or to apply the overlay approach to qualifying assets.

[1] This temporary exemption approach permits an entity to defer the application of IFRS 9 in its financial statements. It can only be applied by a reporting entity if the entity's activities are predominantly "related to insurance", as quantified and tested by a predominance ratio. If selected, the deferral will be applied to all financial instruments of the reporting entity.

[2] In the overlay approach, an insurance entity would adopt IFRS 9, but remove from profit or loss the effects of some accounting mismatches that may occur before adoption of IFRS 4 Phase II, and recognise those impacts in Other Comprehensive Income (OCI) temporarily. The adjustment only applies to financial assets that are designated as relating to contracts in the scope of IFRS 4, and measured at fair value through profit or loss (FVPL) in accordance with IFRS 9, but would not have been measured in their entirety as at FVPL under IAS 39.

Overview

During the May meeting, the International Accounting Standards Board (IASB or the Board) concluded redeliberations on the proposed amendments to IFRS 4 *Insurance Contracts* (IFRS 4) to allow entities issuing contracts within the scope of IFRS 4 to mitigate certain effects of applying IFRS 9 *Financial Instruments* (IFRS 9) together IFRS 4 before the new insurance contracts standard (IFRS 4 Phase II) becomes effective.

The Board also made additional tentative decisions on the temporary exemption and the overlay approach. It then gave staff permission to prepare a ballot draft of the final amendments.

The story so far

In December 2015, the IASB issued the ED that proposed the temporary exemption and the overlay approach to address concerns about implementing IFRS 9 *Financial Instruments* before the forthcoming insurance contracts standard comes into effect. During 2016, the IASB has been redeliberating the proposals in the ED in light of the feedback received in comment letters and other outreach that it performed.

The IASB's website provides information about the ED, the comments received, and the status of the redeliberations, and tentative decisions taken to date: http://www.ifrs.org/Current-Projects/IASB-Projects/Different-effective-dates-of-IFRS-9-Financial-Instruments-and-the-new-insurance-contracts-Standard/Pages/default.aspx

Temporary exemption-reassessment of predominance

During the meeting, the staff outlined their recommendation for the circumstances in which an entity may be required or permitted to reassess eligibility for the temporary exemption from applying IFRS 9. The Board confirmed these proposals.

Mandatory reassessment:

The Board decided that an entity that is eligible for the temporary exemption from applying IFRS 9 will be required to reassess whether its activities are still 'predominantly related to insurance' if and only if there has been a demonstrable change in the corporate structure of the entity that could result in a change in the predominant activities. Examples of such a change include acquisition or disposal of a business.

An entity should re-calculate the predominance ratio at the end of the annual reporting period in which the change in corporate structure takes place. If the entity concludes that its activities are no longer predominantly related to insurance, the entity is required to apply IFRS 9 from the earlier of:

- Its second annual period after the change in corporate structure that changed its predominant activities

Or

- Its annual reporting period that begins on or after the fixed expiry date of the temporary exemption

The Board unanimously agreed that these requirements should provide entities with sufficient lead time for implementation, given that IFRS 9 was issued in full more than two years before the earliest possible reassessment date.

Once the amendments become effective, an entity will also need to disclose that it is no longer eligible to apply the temporary exemption. It must disclose the fact that it is no longer eligible, the reason why it reached this conclusion, and the date on which the change in corporate structure occurred that made it ineligible. This disclosure must be made in both the annual reporting period in which it reaches a change in conclusion and the subsequent annual reporting period (the year before it adopts IFRS 9).

Optional reassessment:

The Board agreed with the staff recommendation that an entity that previously was not eligible for the temporary exemption should be permitted to reassess its eligibility if, and only if, there has been a demonstrable change in the corporate structure of the entity before the mandatory effective date of IFRS 9 (i.e., 1 January 2018) that could result in a change in the predominant activities of the entity.

The entity should re-calculate the predominance ratio at the end of the annual reporting period in which the change in corporate structure takes place.

A demonstrable change in an entity's corporate structure that could result in a change in its predominant activities must be significant to the operations of the entity and demonstrable to external parties. This guidance is analogous to that provided in IFRS 9 in respect of reclassification of financial assets as a result of a change in business model and the Board commented that this should provide market discipline and clarity that only significant events would trigger reassessment.

An entity that becomes eligible for the temporary exemption in this way must disclose the reason for the reassessment, an explanation of the change in its predominant activities and the date on which the change in corporate structure occurred that made it eligible.

This option is not available where an entity previously adopted any version of IFRS 9 (other than the "own credit" requirements in isolation).

All Board members agreed with the proposal.

Temporary exemption and overlay approach - other issues

The Board unanimously agreed with the staff's recommendation that an entity must stop applying the temporary exemption from IFRS 9 no later than for annual reporting periods beginning on or after 1 January 2021.

An entity that previously elected to apply the temporary exemption may, at the beginning of any subsequent annual reporting period, choose to stop applying the temporary exemption and start applying IFRS 9 (either with or without application of the overlay approach).

The Board also confirmed that an entity that stops applying the temporary exemption: (i) must apply the transitional requirements for IFRS 9; and (ii) is permitted to apply the overlay approach until it applies the forthcoming insurance contracts standard.

Some respondents to the ED had suggested a fixed expiry date should also apply to the overlay approach. However, the Board agreed with the staff proposals that the overlay approach will not be subject to such an expiry date. One Board member noted that the overlay approach was developed to address additional mismatches and volatility created by adopting IFRS 9 in advance of the contract for insurance contract liabilities, and provides valuable information. It must therefore remain for the period during which such mismatches apply (i.e., until the entity first applies the new insurance contracts standard), rather than having a fixed expiry date.

13 Board members were in favour and one Board member voted against.

The Board also unanimously confirmed the proposals in the ED that the temporary exemption must be effective for annual reporting periods beginning on or after 1 January 2018 and the overlay approach should be effective when an entity first applies IFRS 9 (other than "own credit" requirements in isolation).

Temporary exemption and overlay approach – relief from IAS 28

At a previous meeting, the Board confirmed that eligibility for the temporary exemption would be at the reporting entity level only.

At the meeting, the Board agreed to provide relief from the requirement in IAS 28 *Investments in Associates and Joint Ventures* (IAS 28) to use uniform accounting policies when using the equity method to account for interests in associates and joint ventures by allowing an investor to retain the associate's or joint venture's accounting for financial instruments under the temporary exemption in the financial statements of the investor.

This decision responds to concerns that if an investor is not subject to the temporary exemption, and applies IFRS 9, but the investee is subject to it and applies IAS 39 in its own financial statements, there could be significant work to conform the investee's accounting in line with those of the investor under IFRS 9.

The relief also applies to an investor that applies the temporary exemption but its investees do not.

This relief is available on an investment-by-investment basis and the choice whether to apply the relief is irrevocable.

One Board member was concerned that this could allow an investor to 'cherry pick' the approach taken for an investment and therefore lead to a lack of consistency. However, other Board members commented that the irrevocable nature of the proposed election under IAS 28 avoids an investor being able to switch.

The Board concluded that a similar relief for investors with associates and joint ventures that apply the overlay approach was not necessary.

The Board had previously confirmed that an entity may elect to apply the overlay approach only when it first applies IFRS 9, and if it does not elect to apply it at that point, it cannot apply it in subsequent periods.

The Board also agreed on a disclosure package that will require an investor to reproduce the disclosures with regard to the temporary exemption or the overlay approach included in its investees' financial statements subject to materiality. The disclosed amounts should be prepared consistently with the requirements for summarised financial information in IFRS 12.

Temporary exemption and overlay approach – application by first-time adopters

At a previous meeting, the Board had tentatively agreed that first-time adopters of IFRS (FTAs) should not be allowed to apply the proposed amendments to IFRS 4.

In response to the feedback received, the Board agreed to amend the ED proposals by permitting FTAs:

- To apply the temporary exemption when they meets the qualifying criteria. When FTAs assessing whether they meet the predominance criterion on the date of assessment, they must use the carrying amounts of liabilities applying applicable IFRS standards
- To apply the overlay approach to qualifying assets. FTAs that apply the overlay approach must restate comparative information to reflect the overlay approach when they restate comparative information in accordance with IFRS 1 (rather than IFRS 9)

This change addresses concerns raised by some respondents about the assumption in the ED that changing from national GAAP to IAS 39 and then, subsequently, to IFRS 9 is less efficient than changing from national GAAP to IFRS 9 immediately. These respondents noted that there are cases where an FTA's national GAAP is not significantly different from IAS 39. Therefore, the position of such FTAs is akin to existing IFRS preparers and they should have the same options available.

The staff was asked to clarify during the drafting process that FTAs adopting the temporary exemption will still have to adopt all IFRSs, meaning they are not exempt from adopting IAS 39, so they cannot simply continue to carry forward their national GAAP accounting for financial instruments.

All Board members were in favour of the proposal.

Permission to ballot

All the Board members agreed that all the mandatory due process steps have been met for the amendments to IFRS 4.

They also agreed that the amendments to IFRS 4 should be finalised without the need for further re-exposure, since the changes made to the ED proposals during redeliberations are not fundamental. The Board has responded to feedback received, and outreach was also conducted to seek the views of preparers and users of financial statements and regulators during this process.

Therefore, the Board unanimously granted the staff permission to begin the balloting process for the amendments.

One Board member expressed an intention to dissent from the issuance of the final amendments. The basis for this Board member's intended dissent is that she believes the temporary exemption from IFRS 9 would result in a loss of information, which would outweigh concerns raised by constituents given that they could be addressed sufficiently by the overlay approach alone.

The Board plans to issue the final amendments in September 2016.

How we see it

By completing its redeliberations on amendments to IFRS 4, the Board has provided some certainty to insurers on whether, and how, they should apply IFRS 9 before they apply the forthcoming insurance contracts standard. In our view, the critical decisions were made in March and April, when the Board decided not to allow entities to defer IFRS 9 below the level of a reporting entity (i.e., an entity must not apply a mix of IAS 39 and IFRS 9 to its financial instruments) and to broaden the eligibility for the temporary exemption. This month's decisions to provide relief from the requirement for uniform accounting policies by investors, associates and joint ventures, and to allow FTAs to apply the temporary exemption, will be welcomed by the industry. These decisions will probably only affect a limited number of entities in practice. The Board also confirmed the expiry date of 2021 for the temporary exemption, indicating that this is the latest effective date that it expects for a revised insurance contracts standard.

What's next?

Having concluded its redeliberations on the amendments to IFRS 4, the Board has provided the staff with permission to begin the balloting process for the amendments. The aim of the staff and the Board remains to issue final amendments to the existing IFRS 4 by September 2016.

In parallel to the balloting process, the staff will continue to work on the drafting process for the new insurance contracts Standard (IFRS 4 Phase II). The process is expected to take up the remainder of 2016. During this process, the Board may engage in targeted consultation on the wording of the new standard. The Board will decide on the effective date of the new standard in due course.

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