Insurance Accounting Alert

December 2015

IASB issues proposal to address the different effective dates of IFRS 9 and the new insurance contracts standard

What you need to know

- ► The IASB issued an ED with proposed amendments to IFRS 4 to address the effects of different effective dates of IFRS 9 and the new insurance contracts standard.
- ► Entities issuing insurance contracts will still be able to adopt IFRS 9 on 1 January 2018 without any further specific changes.
- ► In addition, the ED introduces two alternative options to entities issuing contracts within the scope of IFRS 4, notably the overlay approach and the deferral approach.
- ► The deferral approach provides the entity, if eligible, with a temporary exemption from applying IFRS 9. The overlay approach allows an entity to remove from profit or loss the effects of some of the accounting mismatches that may occur before the new insurance contracts standard is applied.
- ► Comments are due on 8 February 2016.

Overview

On 9 December 2015, the International Accounting Standards Board (IASB or the Board) issued the exposure draft, *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts* (Proposed amendments to IFRS 4) (the ED). The ED proposes to amend the existing IFRS 4 *Insurance Contracts* (existing IFRS 4) to allow entities issuing insurance contracts within the scope of IFRS 4 to mitigate certain effects of applying IFRS 9 *Financial Instruments* before the new insurance contracts standard (IFRS 4 Phase II) becomes effective. This ED therefore reflects an important step to resolve the issue of different effective dates for IFRS 9 (1 January 2018) and IFRS 4 Phase II (still to be decided, but not before 1 January 2020). Comments are due on 8 February 2016.

Reasons for issuing the ED

In July 2014, the IASB issued its new standard on financial instruments, IFRS 9, with an effective date of 1 January 2018. During the re-deliberations on the Board's insurance contracts project, many constituents commented that the effective dates of IFRS 9 and IFRS 4 Phase II should be aligned to take into account the strong interaction between the accounting for insurance liabilities and the financial assets backing those liabilities. However, as a result of delay to the anticipated timetable for IFRS 4 Phase II, the Board concluded that it would be impossible to issue a new insurance contracts standard with an effective date that would be aligned with IFRS 9.

Several interested parties, in particular 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 with IFRS 4 Phase II based on the following arguments:

1. Additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before IFRS 4 Phase II
2. Reassessment of the classification and measurement of financial assets would be required when adopting the new insurance contracts standard to minimize accounting mismatches
3. Two sets of major accounting change in a short space of time could result in significant cost and effort for both users and preparers of financial statements

The Board evaluated these concerns and concluded that the options in the existing IFRS 4[1] and the transition requirements in the future insurance standard[2] are not sufficient to address the issues raised in respect of the application of IFRS 9 before IFRS 4 Phase II.

The IASB therefore decided to develop a targeted proposal to address accounting mismatches (and the resulting additional temporary volatility in profit or loss) arising from the different effective dates of IFRS 9 and the new insurance contracts standard. This proposal also addresses the concerns over the additional cost and effort for preparers and users of financial statements as a result of applying two consecutive sets of major accounting changes in a short period of time.

Overview of the ED proposal

Entities issuing insurance contracts will still be able to adopt IFRS 9 on 1 January 2018 without any further specific changes. In addition, the ED introduces two alternative options that will allow entities issuing contracts within the scope of IFRS 4 to either:

- Apply a temporary exemption from applying IFRS 9 until the earlier of the effective date of a new insurance standard and annual reporting periods beginning on or after 1 January 2021. This exemption will only be available to entities whose predominant activity is issuing contracts within the scope of the existing IFRS 4 (deferral approach)

Or

- Adopt IFRS 9 but, for qualifying financial assets, remove from profit or loss the effects of some of the accounting mismatches that may occur before the new insurance contracts standard is implemented (overlay approach)

The ED proposes to include these alternative options in the existing IFRS 4 rather than changing IFRS 9.

How we see it

Many insurers will welcome the IASB's proposal to include the possibility to defer IFRS 9 until IFRS 4 Phase II becomes effective (or, if earlier, 1 January 2021). Even though there will be reduced comparability for a number of years, the IASB's desire to address the consequences of having different effective dates for IFRS 4 Phase II and IFRS 9 is understandable. As proposed by the IASB, the solution should be optional so companies can still apply IFRS 9 without an adjustment starting 1 January 2018. It is also important that any solution should come from the IASB in order to retain a level-playing field for all IFRS reporters.

Insurance groups will need to conduct an analysis to determine which parts of their group are eligible for deferral, what the impact of IFRS 9 will be, and how the individual entity reporting requirements interact in order to determine the best course of action should the ED proposals be representative of the final standard.

Deferral approach

The deferral approach offers the entity a temporary exemption from applying IFRS 9 in its financial statements. If selected, the deferral approach will be applied to all financial instruments of the reporting entity. However, the deferral approach can only be applied by a reporting entity if a predominant part of its business is devoted to the activity of issuing contracts within the scope of IFRS 4 and if it has not applied IFRS 9 previously[3].

Predominance

The test for predominance is based on the proportion that gross liabilities arising from contracts within the scope of IFRS 4 bear to the entity's total liabilities. The ED does not state a specific threshold for when an entity's insurance activities would

[1] The existing IFRS 4 allows entities to change accounting policies voluntarily for insurance contracts if the change makes the financial statements more relevant to the economic decision-making needs of users, but no less reliable (or vice versa). In addition, the existing IFRS 4 allows the selection of current market interest rates for the discounting of insurance liabilities and the adoption of shadow accounting.

[2] As part of its insurance contracts project, the Board plans to include transition provisions in the new insurance contracts standard that allow insurers to revisit certain areas of the classification and measurement of financial assets under IFRS 9 when adopting the new insurance contracts standard.

[3] IFRS 9 allows an entity to early apply the "own credit" requirements for non-derivative financial liabilities before the final version of IFRS 9 is applied. These provisions require an entity to present in OCI the fair value gains and losses attributable to changes in the entity's own credit risk for non-derivative financial liabilities designated as measured at FVTPL. An entity may still choose to apply the deferral approach if it early applied these "own credit' requirements or decide to early adopt these requirements in a later year and continue to apply the deferral approach.

be considered predominant. However, the Board felt that "predominant" should represent a high hurdle to ensure that only "pure" insurance entities would be captured by the deferral approach, and not entities that issue insurance contracts but also have for example substantial banking activities. To clarify the Board's intent, the Basis for Conclusions in the ED states that an entity for which 75% of its liabilities arose from contracts within the scope of IFRS 4 would not meet the predominance condition. The Board decided to base the predominance test on a single quantitative factor to avoid the potential complexity and subjectivity of a broader set of qualitative and quantitative criteria.

An entity should assess whether insurance activities are predominant at the date when it would otherwise be required to initially apply IFRS 9 (i.e., for annual periods beginning on or after 1 January 2018). Entities should reassess whether the insurance activities are still predominant subsequently if there is a demonstrable change in corporate structure (e.g.,acquisitions or disposals) that could result in a change of the predominant activities. If an entity's insurance activities are no longer predominant, it would have to start applying IFRS 9 from the beginning of the next annual reporting period.

Reporting entity level

The deferral option applies to all financial instruments at the reporting entity level. So, for example, a conglomerate financial institution would determine whether it is eligible for the deferral approach on the basis of the consolidated financial statements of the conglomerate. If this reporting entity then chooses to apply the deferral approach, all the financial instruments in the consolidated financial statements of the reporting entity will continue to be accounted for under IAS 39 *Financial Instruments: Recognition and Measurements*.

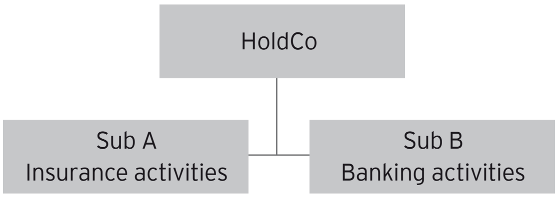
Subsidiaries within the conglomerate that issue their own (separate, individual or consolidated) IFRS financial statements would assess the eligibility criteria at their reporting entity level for the purpose of their financial statements.

Diagram 1 provides an overview of the application of the deferral approach at the reporting entity level.

Diagram 1: Determining eligibility at the reporting entity level

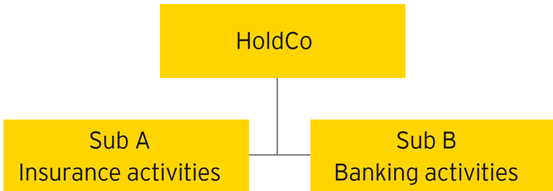
IFRS 9   IAS 39

- If the predominant activity of the conglomerate is an insurance business



- The conglomerate could have the option to continue to apply IAS 39 to all financial assets in consolidated financial statements
- However, if Subsidiary B publishes stand-alone financial statements it must apply IFRS 9

- If the predominant activity of the conglomerate is not an insurance business



- The conglomerate must apply IFRS 9 to all financial assets in consolidated financial statements
- However, if Subsidiary A publishes stand-alone financial statements it could have the option to continue to apply IAS 39

Source: IASB Project Overview "Application of the new accounting requirements for financial assets by insurers'

The proposal in the ED does not allow determination of eligibility for, and application of deferral below, the reporting entity level in the financial statements of that reporting entity. The Board concluded application below the reporting entity level would be challenging and complex as a result of, for example, the simultaneous application of IAS 39 and IFRS 9 by the same entity, the existence of different regulations on what is a legal insurance entity, and the possibility of transfers of financial assets between different components of a reporting entity.

Disclosure

The Board decided that deferral should be optional rather than mandatory, and requires appropriate disclosures to allow comparability. If a reporting entity chooses to apply the deferral approach, it must disclose this fact along with an explanation of why it is eligible. Furthermore, the entity will need to disclose the following information about the characteristics and credit quality of its financial assets:

- The fair value at the end of the reporting period and the fair value change during the reporting period of financial assets that would not meet the "solely principal and interest" characteristic test in IFRS 9 and would therefore be measured at FVPL under that standard
- The gross (i.e., before deducting any impairment amounts) carrying amounts at the end of the reporting period of and credit risk information about financial assets that would not be required to be measured at fair

value through profit or loss (FVPL) under IFRS 9, aggregated by credit risk rating grades. The Board clarifies in the ED that financial assets that would not be required to be measured at FVPL under IFRS 9 include assets that meet the 'solely principal and interest' characteristic test and are not held for trading or managed on a fair value basis.

As a result, an entity will have to collect information on an IFRS 9 basis to provide the disclosures required under the deferral approach. The Board members believe the above set of disclosures provides information that would allow users of financial statements to make certain key comparisons of financial assets While ensuring that the disclosure requirements are not so onerous and costly as to negate the impact of deferral itself.

Transition

An entity will have the option to stop applying the deferral approach at the beginning of any annual reporting period, before the new insurance contracts standard becomes effective. An entity will be required to stop applying the deferral approach when it no longer qualifies, based on a demonstrable change in the corporate structure, when the new insurance contracts standard becomes effective or when the sunset clause expires (see below). When an entity stops applying the deferral approach and applies IFRS 9 for the first time, the entity should follow the transition provisions in IFRS 9.

If an entity's insurance activities would no longer be predominant and as such it would have to start applying IFRS 9 from the beginning of the next annual reporting period, it discloses the fact that it is no longer eligible for deferral, the reason why it is no longer eligible, and the date on which the related change in corporate structure took place.

The deferral option expires for reporting periods beginning on or after 1 January 2021 (sunset clause). This means that if the new insurance contracts standard is not applied from the beginning of 2021, an entity will have to apply IFRS 9. However, an entity may elect to apply the overlay approach when it first applies IFRS 9 and the overlay approach could be used until the new insurance contracts standard becomes effective.

Once an entity has adopted IFRS 9, either together with, or without the overlay approach, it is not permitted to stop applying IFRS 9 and revert to applying IAS 39 under the deferral approach.

How we see it

Many insurers will welcome the decision by the IASB to include the option of deferral in the ED. The comment letters are likely to raise a number of questions and concerns about the deferral approach, particularly on the eligibility requirements for this approach. Of course, if the Board's intent is to provide a solution for the insurance industry, the scope should be sufficiently broad for this purpose. However, redeliberating the eligibility criteria will require careful consideration based on the feedback of both preparers and users. Bearing in mind that the IASB Chair used his casting vote in the September Board meeting following a tied vote on the deferral approach, redeliberation of some of the sensitive areas and disclosure requirements is likely to be challenging.

Overlay approach

The overlay approach can be applied by an entity that both issues contracts in the scope of IFRS 4 and applies IFRS 9. The overlay approach allows an insurance entity to exclude from profit or loss certain effects of IFRS 9 and reclassify these effects to Other Comprehensive Income (OCI). This reclassified amount (overlay adjustment) only applies to financial assets which are both:

- Designated as relating to contracts in the scope of IFRS 4
- Measured at FVPL in accordance with IFRS 9 but would not have been measured in their entirety as FVPL under IAS 39

The ED refers to financial assets that meet these two conditions as 'qualifying financial assets'.

The overlay adjustment for qualifying financial assets is determined as the difference between:

- The amount reported in profit or loss in accordance with IFRS 9
- The amount that would have been reported in profit or loss under IAS 39

Under the overlay approach, an entity applies IFRS 9 in the Statement of Financial Position (SFP or balance sheet) and the Statement of Comprehensive Income (SCI), but eliminates the additional impact of IFRS 9 in profit or loss for all financial assets in scope. Profit or loss would be the same as it would have been under IAS 39 for all assets to which the overlay approach is applied. As a consequence, the profit or loss amount reported by the entity contains a mix of IFRS 9 and IAS 39 measurements for financial assets. For example, impairments would be based on the incurred loss model for impairments under IAS 39 for financial assets to which the overlay approach is applied and on the expected credit loss model under IFRS 9 for other instruments.

Designation

One of the two eligibility criteria for a qualifying asset is that it has to be designated as relating to contracts within the scope of IFRS 4. An entity will have to establish its designation of financial assets that relate to contracts within the scope of IFRS 4 and disclose the basis for identifying such assets. The Board explains entities cannot include assets clearly held in respect of activities other than contracts within the scope of IFRS 4, such as financial assets held by a banking subsidiary (that does not issue contracts within the scope of IFRS 4) or financial assets held in funds clearly related to investment contracts that are outside of the scope of IFRS 4. The Board acknowledged that different entities could apply different approaches to designating financial assets.

The designation requirements imply that an entity is not required to apply the overlay approach to all financial assets that are eligible. The Board concluded that there may be eligible financial assets for which the entity might reasonably decide that the cost of applying the overlay adjustment outweighs any benefits in reducing volatility in profit or loss.

The designation of a financial asset as relating to contracts within the scope of IFRS 4 may change over time only if there is a change in the relationship between this asset and the insurance contracts, which would reflect a substantive change in the purpose for which the financial asset is held:

- An entity may newly designate an asset if there is such a change, for example, if an asset is transferred from a non-insurance business segment to an insurance business segment
- If an entity previously designated an asset as relating to insurance contracts and this relationship changes, the entity is required to de-designate this asset, for example, an asset is transferred between an insurance business segment and a non-insurance business segment

When a financial asset first meets the eligibility criteria and the entity elects to apply the overlay approach to the asset, it must do so on a prospective basis. When a financial asset no longer meets the eligibility criteria, the amount of the overlay adjustment in accumulated OCI for that asset will be immediately reclassified ("recycled") to profit or loss.

To address any concerns about the potential to transfer or redesignate financial assets to achieve a particular accounting outcome, entities will have to disclose the effects on profit or loss and OCI of financial assets that move in and out of the overlay approach as a result of transfers within the group or re-designation. To the extent an entity does not separately identify the effect of the overlay adjustment on line items on the face of the profit or loss account, this disaggregation should be shown in the note disclosures.

Presentation

A single line item for the amount of the overlay adjustment should be presented in either profit or loss or OCI, or both. This means entities can also disaggregate the adjustment amount in profit or loss to allow them to provide information about profit or loss effects under both IFRS 9 and IAS 39 in the most useful way.

Disclosure

An entity that applies the overlay approach will have to make disclosures for each reporting period about the fact that it applies the overlay adjustment, the classes and carrying amounts financial assets to which this adjustment relates, and the policy for determining the assets to which the overlay adjustment is applied.

The ED also requires that entities provide an explanation of the amount of the total overlay adjustment in each period in a way that enables users of the financial statements to understand how it is derived. If an entity changed the designation of financial assets during the reporting period:

- The amount of overlay adjustment in profit or loss and OCI relating to financial assets that are newly within the scope of the overlay approach in the period
- The amount of overlay adjustment that would have arisen in profit or loss and OCI in the period if financial assets had not been removed from the scope of the overlay approach
- The amount of overlay adjustment in the period due to the reclassification of amounts in accumulated OCI to profit or loss in respect of financial assets removed from the scope of the overlay approach

Transition

An entity cannot apply the overlay approach before it applies IFRS 9[4]. On transition to IFRS 9, the overlay approach, if selected, must be applied retrospectively, resulting in an adjustment to opening accumulated OCI based on the difference between:

- The fair value of financial assets to which the overlay approach is applied
- Amortised cost or cost carrying amount of these assets determined in accordance with IAS 39 immediately prior to transition to IFRS 9

If an entity restates comparatives under IFRS 9, it should also restate comparative amounts for the overlay adjustment.

An entity will have to cease the application of the overlay approach when it first applies the new insurance contracts standard. An entity is permitted to stop applying the overlay approach in any reporting period before adopting the new insurance contracts standard. When an entity stops applying the overlay approach, the remaining balance in accumulated OCI will be recycled to profit or loss at the beginning of the earliest comparative period presented (or, if later, the beginning of the period when the overlay approach was first applied).

How we see it

Unlike the deferral approach there is no predominance threshold; entities would have to apply IFRS 9 and establish a designation of financial assets supporting liabilities in the scope of IFRS 4. This means that entities not qualifying for the deferral approach could still make use of the overlay approach. However, the application of the overlay option, and the calculations required to implement it, may be complex. This will particularly be the case when the accounting for insurance contract liabilities is affected by the amount of investment income recognized in profit or loss (for example, for insurers applying shadow accounting). Furthermore, entities will have to maintain processes, systems and data to enable parallel reporting under IAS 39 and IFRS 9.

[4]IFRS 9 allows an entity to early apply the "own credit" requirements for non-derivative financial liabilities before the final version of IFRS 9 is applied. An entity may still choose to apply the overlay approach if it early applied these "own credit" requirements.

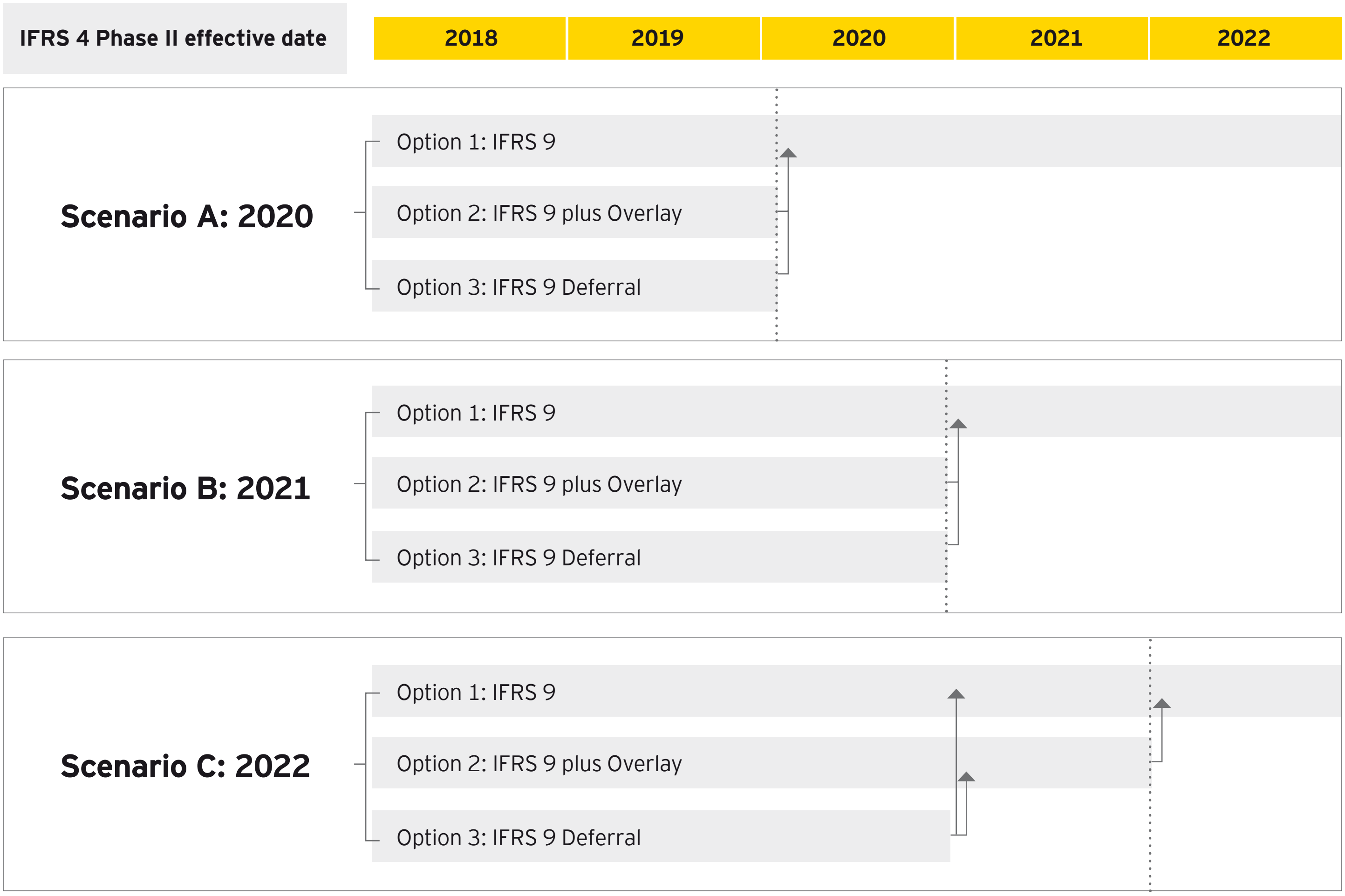
Effective date

The amendments proposed in the ED will become effective for reporting periods beginning on or after 1 January 2018. Early adoption of the proposed amendments is permitted if an entity adopts IFRS 9 early. The deferral and overlay approaches will only be available to an entity if it has not previously applied IFRS 9.

The Board concluded that 1 January 2018 would be an appropriate effective date because entities should not need an extensive implementation period as the overlay approach builds on information already reported in accordance with IAS 39, and the deferral approach is a temporary exemption from IFRS 9 requirements except for specific disclosures which will still be required on full implementation of IFRS 9.

Diagram 2 summarizes the various implementation routes an entity may choose from, based on three potential scenarios for the effective date of IFRS 4 Phase II.

Diagram 2: Potential implementation routes



Entities adopting IFRS for the first time on or after 1 January 2018 will not be able to use either the deferral approach or the overlay approach under the proposal in the ED.

Interaction with transition provisions for financial assets in IFRS 4 Phase II

Upon adoption of IFRS 4 Phase II, an entity either already applies IFRS 9 or will have to stop applying IAS 39 and adopt IFRS 9 at that moment. Considering the interaction between the insurance liabilities and the assets backing these liabilities, the Board decided to include transition provisions for the classification and measurement of financial assets in the new insurance contracts standard. These IFRS 4 Phase II transitional provisions apply if an entity already applies IFRS 9, either together with, or without the overlay approach, and would allow the entity to:

- Make designations and de-designations of financial assets under the Fair Value Option and the OCI presentation election for investments in equity instruments
- Reassess the business model for classification and measurement of financial assets under IFRS 9

The entity is required to apply the classifications resulting from these relief provisions retrospectively (i.e., as if the financial assets had always been so classified).

Entities that have previously applied IFRS 9, will be permitted (but not required) to restate comparative information about financial assets under the transition provisions in the new insurance contracts standard, provided this is possible without hindsight. This approach is in line with the transition provisions of IFRS 9, which do not require restatement and only allow it if this can be done without the benefit of hindsight. The Board concluded that restatement of the business model on application of IFRS 4 Phase II should not be inconsistent with the requirements of IFRS 9.

An entity that adopts IFRS 9 at the same time that it adopts IFRS 4 Phase II will be able to apply the transitional provisions of IFRS 9, which also include certain designations and de-designations of financial assets.

What will happen next?

Now the ED has been issued, a 60-day comment period follows. The consideration of comments and the redeliberations by the Board may result in changes to the proposals as included in the ED.

The Board may feel it has undertaken significant efforts to address and resolve concerns over different effective dates for IFRS 9 and IFRS 4 Phase II, but it will be interested to hear about potential issues. Preparers and users will, therefore, need to carefully understand and evaluate the potential impact of the proposals in the ED, in order to provide effective feedback in their comment letters and help the Board to develop a well-balanced solution for the different effective dates for IFRS 9 and IFRS 4 Phase II.

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