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Insurance Accounting Alert

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IASB decides to mitigate impact of applying IFRS 9 before IFRS 4 Phase II

What you need to know

- The IASB agreed unanimously to address concerns about additional accounting mismatches and volatility arising from the different effective dates of IFRS 9 and the new insurance contracts standard.
- As a result of their tentative decision, upon application of IFRS 9, any additional amounts recognised in profit or loss (compared to that arising from applying IAS 39) will be recorded directly in equity through in OCI for instruments that are classified as FVPL under IFRS 9 but previously were, or would have been, classified as amortised cost or AFS under IAS 39.
- The Board plans to discuss the potential deferral of IFRS 9 for insurance entities at a future meeting.

Overview

During its July meetings, the International Accounting Standard Standards Board (IASB or the Board) continued re-deliberations on possible ways to mitigate the impact of adopting IFRS 9 *Financial Instruments* (IFRS 9), in advance of the new insurance contracts standard (IFRS 4 Phase II), via modifications to the existing IFRS 4 *Insurance Contracts* standard (IFRS 4, or the existing IFRS 4). In particular, the Board focused on three possible additional changes to the existing IFRS 4 to mitigate additional accounting mismatches and volatility in profit or loss that could arise when applying IFRS 9 before IFRS 4 Phase II:

a) Permitting shadow accounting to be applied to the shareholder's share of assets underlying participating contracts
b) Permitting shadow accounting to be applied to non-participating contracts
c) Allowing an entity to make adjustments to offset the effect of IFRS 9 in profit or loss for certain investments.

The story so far

The IASB's website provides information about tentative decisions made on the insurance contracts accounting model prior to this meeting, including:

- The cover note for the Board's papers on insurance for the July meeting which contains a summary of progress so far[1]
- Further information on the project and the proposed model[2]

Additional accounting mismatches and volatility that could arise on application of IFRS 9 in advance of IFRS 4 Phase II

IFRS 9 introduces new classification and measurement categories for financial assets, along with requirements that need to be met before the various categories can be used. For debt instruments, IFRS 9 allows classification (depending on the characteristics of the instrument and the business model under which it is held) as either:

- Amortised cost
- At fair value through other comprehensive income (FVOCI)

Or

- At fair value through profit and loss (FVPL)

Equity instruments are classified as either:

- FVPL

Or

- FVOCI

For items classified as amortised cost or FVOCI, IFRS 9 requires that impairment be calculated in line with its expected credit loss model.

The new requirements mean that certain financial assets will change classification as insurers move from IAS 39 to IFRS 9, with an accompanying change to the timing of recognition of gains and losses in profit and loss. The introduction of the expected credit loss impairment model is also likely to change profit and loss for those insurers that will have instruments carried at either amortised cost or FVOCI.

IFRS 9 is currently effective for periods beginning on or after 1 January 2018. It is likely that the new insurance contracts standard will have a later implementation date. Therefore, the IASB sought, in this meeting, to address some of the impacts that would arise in the interim period between the effective dates of the two new standards.

The staff presented a background paper outlining possible consequences of applying IFRS 9 in advance of IFRS 4 Phase II. Key issues identified by the staff were temporary increases in accounting mismatches and volatility in profit or loss. Accounting mismatches could arise in profit or loss when insurance contract liabilities are measured based on a locked-in discount rate, but changes in the fair value of assets are reported in profit or loss. This could be the case under both IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9, but effects may increase under IFRS 9, where financial assets that are currently held at amortised cost or as available for sale (AFS) in IAS 39 could be required to be classified as FVPL under IFRS 9. An example would be debt instruments not meeting the "solely payment of principle and interest" criteria, or equity instruments to which the entity does not choose to apply the OCI presentation option in IFRS 9.

When gains and losses on assets have an effect on the measurement of insurance contract liabilities, a difference in measurement of the liabilities and underlying assets for accounting purposes can give rise to an accounting mismatch even when there is no, or only a limited, economic mismatch. Additional profit or loss volatility could also arise from changes in the shareholder's interest in financial assets underlying participating contracts when such assets are carried at FVPL. Such volatility in profit or loss is not expected to arise under IFRS 4 Phase II because of the variable fee approach, so this is viewed by the staff as temporary volatility (for those contracts that will qualify for using the variable fee approach).

[1] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/July/AP02-Insurance-contracts.pdf
[2] http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Insurance-Contracts.aspx

The staff noted that some entities had raised concerns around the temporary application of the new impairment model in IFRS 9. The entities commented that, when both IFRS 4 Phase II and IFRS 9 are effective, they may consider applying the fair value option to debt instruments to achieve consistent accounting between financial assets and insurance contract liabilities in profit or loss. However, under the existing IFRS 4, they may choose to carry those same instruments at amortised cost or FVOCI because insurance liabilities are currently measured using locked-in assumptions. Entities would therefore incur the cost of building systems to apply the impairment requirements and forward-looking expected loss models which apply to assets held at amortised cost or FVOCI only until the insurance contracts standard is applied. When a Board member queried whether this is a widespread issue, the staff responded it is likely to be selective rather than widespread.

Staff stated that any solutions considered should be targeted as precisely as possible, addressing only the issues of additional temporary mismatches or volatility created by applying IFRS 9 but no more, with the aim of restricting the application to entities that issue insurance contracts within the scope of IFRS 4. At the same time, staff proposed that a solution should minimise implementation efforts, be understandable to users, and be capable of being adopted quickly.

The staff confirmed that any decisions made during the July meeting would not preclude other solutions, and that, irrespective of possible decisions made at the July meeting, the staff would bring a paper on a potential deferral of IFRS 9 for insurers to a future meeting. The staff also clarified that any solution was expected to be optional rather than mandatory.

Potential amendments to IFRS 4

The staff outlined the options already available in the existing IFRS 4 to reduce accounting mismatches that can occur when applying IAS 39 to financial assets. The staff concluded these options would continue to be relevant when applying IFRS 9 together with the existing IFRS 4 and could possibly be expanded to address any additional accounting mismatches that arise as a result of the introduction of IFRS 9. The existing options identified were:

- The application of shadow accounting[3]
- Selective use of current market interest rates for valuation of liabilities
- The ability provided in existing IFRS 4 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)

The staff noted that these methods do not sufficiently address the issues raised around the application of IFRS 9 before IFRS 4 Phase II. The staff outlined the following three additional approaches as potential changes:

a) Allow a shadow accounting adjustment for the shareholder interests in assets underlying participating contracts. This would extend shadow accounting to encompass shareholders' interests in assets, by allowing an adjustment to liability for shareholders' interests f there is already an equivalent adjustment for the policyholders' share.

b) Permit shadow accounting for non-participating contracts (where the return on assets do not directly affect the liabilities). This would extend shadow accounting by adjusting liabilities for unrealised gains for assets that do not directly relate to those liabilities.

c) Adjustment to profit or loss to offset the effects of IFRS 9 for certain assets. This option is directed at financial assets at FVPL under IFRS 9 that were previously (or would have been) classified as amortised cost or AFS under IAS 39. This would allow an entity to exclude from profit or loss, and recognise instead in OCI, the difference between amounts recognised in profit or loss in accordance with IFRS 9 and the equivalent amounts under IAS 39. This treatment could be applied by an entity that issues insurance contracts and applies IFRS 9. Under this solution, an entity applies IFRS 9 in full in the balance sheet, but eliminates the additional impact of IFRS 9 in profit or loss for all financial assets in scope of the solution. As such, profit or loss would be the same as it would have been under IAS 39 for all in-scope assets. The approach would be implemented by changing the existing IFRS 4 rather than IFRS 9.

After carefully evaluating the pros and cons of each of the above approaches, staff recommended approach C as it would have the fewest issues and would best address the particular issues raised.

Most Board members agreed that, of the three approaches, approach C would be the most responsive to the mismatch and volatility issues raised by the insurance industry and other constituents and felt that it was a simple, pragmatic and transparent solution. Several Board members added that approach C is particularly attractive as it would provide users of financial statements with comparable information (i.e., information on the financial assets under of both IFRS 9 and IAS 39).

Several Board members emphasised that scoping would need to be considered carefully, especially in respect of application within a conglomerate or an insurance entity with banking subsidiaries, to ensure that financial assets related to

[3] Under IFRS 4, shadow accounting adjusts aggregate insurance liabilities to reduce accounting mismatches that can arise when unrealised gains and losses on assets held by the entity are recognised in the financial statements, but corresponding changes in measurement of liabilities are not.

an entity's non-insurance activities remain out of scope. However, these Board members noted they had less concern on this scoping compared with that of a deferral of IFRS 9, because the solution would be temporary and entities would be reporting information on the financial assets in their primary financial statements under both IAS 39 and IFRS 9.

Board members discussed the potential burden of having to produce numbers under both standards but generally considered that this would not really be an issue as long as a decision is made on a timely basis allowing insurers to plan and be aware that they might have parallel application of IFRS 9 and IAS 39 for two or three years. This would not necessarily be overly disruptive given that insurers need to produce fair value information already for measurement on the balance sheet and/or for disclosure purposes. They accepted that there would be some additional cost incurred, but did not expect this to be very significant and one worth paying for the purpose of mitigating additional volatility.

Board members expressed concerns that approaches A and B were not seen to address directly the problem that the Board has been asked to address, and are not sufficiently in line with the direction of the proposals either for participating contracts or non-participating contracts in the new standard, and would just introduce more temporary change, prior to the standard being finalised. However, some board members asked not to disregard approach A entirely at this stage, but to revisit it, if necessary, once the standard is more final.

A few Board members agreed more reluctantly to approach C, as their first choice would be to do nothing other than requiring explanation of the effects through disclosure and referring to existing accounting options under IFRS 4. However, these Board members recognised that, by taking no action, they are not responding to the stakeholders' request.

Before asking for a vote, the staff reiterated that:

- Approach C would only be allowed if an entity issues contracts accounted for under IFRS 4 and applies IFRS 9 in conjunction with IFRS 4.
- Approach C would only apply to financial assets that:
  - Are classified at FVPL in accordance with IFRS 9, when they were previously, or would have been, measured at AC or AFS in accordance with IAS 39
  - Relate to insurance activities
- The staff will further investigate issues raised by the Board such as scope, the transfer of assets within a conglomerate and whether the solution could be applied to assets measured under the fair value option.

Taking into account this clarification by the staff, all Board members voted in favour of approach C.

How we see it

It was clear from this meeting, that the Board is currently more inclined to find a solution through the existing IFRS 4 rather than changing IFRS 9. Although the Board's intention is to keep the preferred solution simple and pragmatic, the issues around scope and transfers may be more challenging than they anticipate. To amend the existing IFRS 4 to make the solution available for insurers to implement, the IASB will need to go through its due process, including the issue of an exposure draft with a comment period. Therefore, time will be required to finalise the change. This will not delay the finalisation of IFRS 4 Phase II because the change will be made to the existing standard.

The approach tentatively selected by the IASB means that, before IFRS 4 Phase II becomes effective, profit or loss will reflect IAS 39 to a certain extent, while shareholder's equity will fully reflect the IFRS 9 measurement. An insurance entity would therefore have to calculate its insurance liabilities considering the impact of both an IAS 39 measurement and an IFRS 9 measurement.

The Board has kept open the possibility that, in addition to this solution, it may agree to other solutions in parallel, such as a deferral of IFRS 9 for insurers. If the IASB were to allow a deferral of IFRS 9, it seems likely that it would also require significant disclosures. This implies that, regardless of which solution is chosen by the IASB, insurers are reminded of the operational requirements because they will have to prepare both IFRS 9 and IAS 39 numbers as from the 2018 financial year regardless of the Board's decision. Insurers should therefore expedite preparations to implement the new standard.

What's next?

The Board's next meeting on insurance contracts is expected to be in September. The topics have not yet been announced, but are likely to include further discussion on the proposed approach outlined above as well as further consideration of the deferral of IFRS 9. The IASB plans to finalise re-deliberations and issue the new standard in the course of 2016.

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