IASB decides to broaden eligibility for the temporary exemption from IFRS 9

What you need to know

The IASB made the following tentative decisions with respect to the temporary exemption from applying IFRS 9 and the overlay approach:

- More entities will be eligible for the temporary exemption from applying IFRS 9 than was proposed in the exposure draft Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Amendments to IFRS 4) (the ED). The predominance ratio to assess if a reporting entity’s activities are predominantly ‘related to insurance’ will include more liabilities in the numerator of the calculation. The denominator remains total liabilities. Entities will need a predominance ratio of over 90% to be automatically eligible for deferral. Entities with a predominance ratio of over 80% and less than or equal to 90% will be able to defer IFRS 9 if they do not have a significant activity unrelated to insurance.

- A prescribed presentation in profit or loss (P&L) and other comprehensive income (OCI) if an entity adopts the overlay approach. P&L will reflect the application of IFRS 9, with a single separate P&L line item for the overlay adjustment and presentation in OCI of the overlay adjustment separately from other components of OCI. Financial assets qualifying for the overlay approach could include surplus financial assets that an entity holds for the purposes of regulatory requirements or internal capital objectives.
Overview

During the April meeting, the International Accounting Standards Board (IASB or the Board) continued its redeliberations on 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 with IFRS 4 before the new insurance contracts standard (IFRS 4 Phase II) becomes effective.

The Board made tentative decisions, allowing for broader eligibility for the temporary exemption from applying IFRS 9 (temporary exemption) and it also evaluated several aspects of the overlay approach.

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 before the forthcoming insurance contracts standard comes into effect. The IASB is currently redeliberating the proposals in the ED in the light of the feedback received in comment letters and other outreach that it performed.


Temporary exemption qualifying criteria

The Board decided to amend the predominance criterion to be used in determining whether an entity qualifies for IFRS 9 deferral.1 In accordance with the amended proposals, an entity is permitted to apply the temporary exemption only if the entity has not previously applied any version of IFRS 9 (except for the ‘own credit’ requirements in isolation) and the entity’s activities are predominantly ‘related to insurance’, where such activities comprise:

- Issuing contracts within the scope of IFRS 4 where these contracts give rise to liabilities whose carrying amount is significant compared to the total carrying amount of the entity’s liabilities
- Issuing investment contracts that are measured at fair value through profit or loss (FVPL) on the basis of IAS 39 Financial Instruments: Recognition and Measurement (IAS 39)

The Board tentatively decided that entities should assess whether the predominance criterion is met on the basis of the ‘predominance ratio’, to be calculated in the following manner:

- Numerator: the sum of the carrying amounts of liabilities arising from activities related to insurance (i.e., liabilities arising from contracts within the scope of IFRS 4 and investment contracts measured at FVPL under IAS 39) and ‘other’ liabilities that are connected to those activities (e.g., funding liabilities that are considered to be part of regulatory capital or solvency requirements for insurance, written put options on non-controlling interests in consolidated investment funds backing insurance liabilities held or derivatives that are economically hedging liabilities arising from contracts within the scope of IFRS 4, etc.).
- Denominator: the total carrying amount of the entity’s liabilities, including all the liabilities included in the numerator.

The predominance criterion would be met only if:

- The predominance ratio is greater than 90%
- Or
- The predominance ratio is greater than 80% but less than, or equal to, 90% and the entity can provide evidence that it does not have a significant activity that is unrelated to insurance.

These criteria reflect the Board’s response to feedback from constituents who recommended broader eligibility for the temporary exemption to achieve an increase in the number of entities that would qualify for deferral of IFRS 9. In particular, these constituents suggested that investment contracts accounted outside the scope of IFRS 4, but accounted for at FVPL, should be included in the calculation of predominance to allow better comparability between peers considered as insurers. In many jurisdictions, these products are sold alongside similar products with significant insurance risk and are regulated as insurance contracts. Many entities considered to be insurers by respondents (including users) are now likely to qualify, but entities with significant activities unrelated to insurance (such as banking) are unlikely to qualify for the temporary exemption.

The staff clarified that deposit components that are unbundled from an insurance contract under the guidance in IFRS 4 are a component of a contract in the scope of IFRS 4 and related to insurance. These unbundled liabilities should therefore be included in the calculation of the predominance ratio.

Having provided a broader set of liabilities to be included in the numerator, the Board decided to set a higher threshold for the predominance ratio. The Board noted that the threshold of 90% will provide what the IASB described as a ‘safe harbour’ of activities predominantly related to insurance, while entities below 90% but above 80%, will require more judgement, with a qualitative and quantitative assessment to determine whether an entity has at least one significant non-insurance related activity.

Some Board members reluctantly provided their support for these thresholds on the basis that they would normally avoid stated bright lines. However, these Board members thought it was acceptable in this case as this is only a temporary exemption that needs to be practical and clear to avoid risk of different interpretations.

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1 Under the initial proposal outlined in the ED, the deferral approach could only be applied by a reporting entity if the predominant part of its business is devoted to the activity of issuing contracts within the scope of IFRS 4. Predominance would be determined on the basis of the level of gross liabilities arising from contracts in the scope of IFRS 4 in proportion to total liabilities; an example in the Basis for Conclusions of the ED indicated that a proportion of 75% would not result in the insurance activities being predominant.
Board members also expressed concern about making the examples of liabilities arising from activities related to insurance too specific, and emphasised that the items listed in the staff papers should be regarded as examples rather than an exhaustive list. The Board requested the staff to consider this in drafting the final amendments. To illustrate this point, a board member asked whether a derivative hedging an asset would be in scope because the example in the staff paper only refers to derivatives hedging liabilities.

The Board considered, and rejected, a staff proposal on how to deal with unusual market fluctuations that could affect the carrying amounts of liabilities within an annual period, for example, where a current discount rate is used to value certain liabilities while others are held at amortised cost. The staff had suggested taking a three-year average in such cases, but this would be overly complex to interpret and would use less relevant historical data. The Board stated that it had already provided an expanded predominance ratio and further relaxation would be provided through the additional assessment for predominance ratios between 80% and 90%. As such, the Board believed the proposals should not be complicated any further.

The Board tentatively decided that an entity should calculate the predominance ratio using the carrying amounts of the liabilities reported on its balance sheet at the annual reporting date between 1 April 2015 and 31 March 2016 (i.e., the assessment date). This time frame will thereby provide time to plan for implementation.

The IASB also confirmed that an entity will need to disclose the fact that it is applying the temporary exemption. As part of its explanation how it determined its eligibility for the temporary exemption, the entity will, where relevant, need to disclose:

- Any liabilities, other than those arising from contracts within the scope of IFRS 4, that are included in the numerator of the predominance ratio (except when the carrying amount of liabilities from contracts within the scope of IFRS 4 is greater than 90% of total liabilities)
- The information used to determine that the entity’s activities are predominantly related to insurance if the predominance ratio is greater than 80% but less than, or equal to, 90%
- Any liabilities, other than those arising from contracts within the scope of IFRS 4, that are included in the numerator of the predominance ratio (except when the carrying amount of liabilities from contracts within the scope of IFRS 4 is greater than 90% of total liabilities)
- The information used to determine that the entity’s activities are predominantly related to insurance if the predominance ratio is greater than 80% but less than, or equal to, 90%

12 of the 13 Board members present voted in favour, and provided guidance to the staff on points to clarify during drafting (one Board member was absent).

**Temporary exemption disclosures**

The Board voted in favour of amending the disclosures proposed in the ED by requiring an entity to disclose the fair value at the end of the reporting period and the fair value change during the reporting period separately for:

- Financial assets with contractual cash flows that are not solely principal and interest (SPPI)
- All other financial assets (i.e., those assets with contractual cash flows that are SPPI).

For the purposes of this disclosure, an asset’s carrying amount measured in accordance with IAS 39 is a reasonable approximation of its fair value if the entity is not required to disclose its fair value in accordance under IFRS 7 Financial Instruments: Disclosures (e.g., short-term trade receivables).

The above disclosures will have to be presented with a sufficient level of granularity to enable users of financial statements to understand the nature and the characteristics of the financial assets.

For financial assets that meet the SPPI test and are not held for trading or managed on a fair value basis, an entity should disclose the fair value and the gross carrying amount (i.e., in the case of amortised cost assets, before adjusting for any impairment allowances) for assets that do not have ‘low credit risk’ at the end of the reporting period.

An entity will need to refer to any IFRS 9 information that is not provided in the consolidated financial statements, but is publicly available for the relevant reporting period in the financial statements of any entity in the group (including the parent entity), that may show IFRS 9 information in its standalone financial statements.

With these tentative decisions, the Board aims to balance the needs of users of financial statements for quantitative information, particularly on credit risk, with the concerns of preparers that disclosures could become overly burdensome and almost as onerous as the adoption of IFRS 9. Several Board members noted that the disclosure of fair value of financial assets should provide an ‘indirect’ way to flag expected credit losses where the fair value is much lower than the carrying value. This, for example, would provide an indication of the population that might need to provide for expected lifetime credit losses.

11 of 13 Board members voted in favour of the proposals.

**Overlay approach**

The Board confirmed most aspects of the overlay approach proposed in the ED, but made some changes.

The Board clarified that financial assets qualifying for the overlay approach could include surplus financial assets that an entity holds for the purposes of regulatory requirements or internal capital objectives. Consequently, such surplus financial assets may be designated as relating to contracts within the scope of IFRS 4.

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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 OCI temporarily.
The Board added the requirement that a reporting entity should disclose, where applicable, the basis for designating financial assets held by one legal entity (that may not issue contracts within the scope of IFRS 4) of the reporting entity as relating to contracts within the scope of IFRS 4 that are issued by a different legal entity within that reporting entity.

12 Board members agreed to the proposals.

The Board decided to prescribe a specific presentation for the overlay adjustments by requiring that an entity presents in P&L, information that reflects the application of IFRS 9, with a single separate line item for the overlay adjustment, and, in OCI, present the overlay adjustment separately from other components of OCI consistent with IAS 1 Presentation of Financial Statements.

The Board also agreed to the staff proposal to disclose the effect of the overlay approach on individual line items in the notes to the financial statements.

The tentative decisions take into account feedback from users who wanted to have a simple presentation, given this is a temporary option only. The staff and Board did not agree with the suggestions raised in feedback to limit assets in scope to those of a single entity or to provide further prescriptive guidance on how assets are defined as related to contracts within the scope of IFRS 4.

12 of the 13 Board members voted in favour.

How we see it

The changes to the qualifying criteria for the temporary exemption from applying IFRS 9 are likely to allow more entities that are generally thought of as insurers to qualify for the temporary exemption. Entities with significant banking activities are unlikely to meet the criteria for temporary exemption and would need to apply IFRS 9 in their consolidated financial statements from 2018.

The Board decided to retain the disclosures that an entity needs to provide when applying the temporary exemption, irrespective of whether assets are currently accounted for as at FVPL under IAS 39 and irrespective of whether an entity anticipates using the fair value option under IFRS 9. As a result, companies that intend to apply the temporary exemption should prepare themselves for providing these disclosures. This preparation is expected to require significant effort, in particular, with respect to implementing processes and systems for the SPPI test and for determining which assets do not have ‘low credit risk’.

What’s next?

The staff intend to bring back remaining issues on the temporary exemption and the overlay approach to the May Board meeting, including: whether an entity needs to reassess if it still qualifies for the temporary exemption in particular circumstances; the availability of the temporary exemption and the overlay approach to first time adopters of IFRS; etc. The aim is to issue final amendments to the existing IFRS 4 by September 2016.

In parallel, the staff are continuing 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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