APPLYING IFRS 9 FINANCIAL INSTRUMENTS WITH IFRS 4 INSURANCE CONTRACTS (AMENDMENTS TO IFRS 4)

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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 contained proposed amendments to IFRS 4 *Insurance Contracts* and was 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, 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 gave 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, in September 2016 the IASB amended IFRS 4 by issuing Applying *IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts* (Amendments to IFRS 4), which confirmed (with some modifications) the proposals in the ED. The amendments to IFRS 4 introduce:

(a) an optional overlay approach that permits insurers to reclassify between profit or loss and other comprehensive income (OCI) an amount equal to the difference between the amount reported in profit or loss for designated financial assets applying IFRS 9 and the amount that would have been reported in profit or loss for those assets if the insurer had applied IAS 39; and
(b) an optional temporary exemption from IFRS 9 for insurers whose activities are predominantly connected with insurance.

STATUS

Amendments to the Standard

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 disclosure 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 issued by the IASB in December 2015 proposed 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.

In September 2016 the IASB amended IFRS 4 confirming, with some modifications, the proposals in the ED.

Although creating options within IFRSs can reduce comparability, the IASB made both the overlay approach and the temporary exemption from IFRS 9 optional. This permits insurers that are eligible for the temporary exemption from IFRS 9 or the overlay approach to choose not to apply them and instead to apply the improved accounting requirements in IFRS 9 without adjustment.

The IASB decided that the temporary exemption from IFRS 9 should not be available for all insurers but rather should be limited to insurers that are significantly affected by the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard. It was concluded that for other insurers the disadvantages of the temporary exemption would outweigh the advantages.

Amendments to IFRS 4 Insurance Contracts

In September 2016 the IASB issued *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts* (Amendments to IFRS 4) to address concerns arising from the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard. Those amendments include a temporary exemption from IFRS 9 for insurers that meet specified criteria and an option for insurers to apply the overlay approach to designated financial assets.

Overlay approach

An insurer applying the overlay approach applies IFRS 9, and consequently provides:

a) the significantly improved information about financial instruments that results from applying IFRS 9, in particular information on credit risk, that will enable improved analysis by users of financial statements; and

b) information about financial instruments that is comparable to the information provided by entities that apply IFRS 9 without the overlay approach.

The overlay approach provides additional information to users of financial statements that will enable them to understand the effects of applying IFRS 9 to the designated financial assets. Applying this approach an insurer adjusts profit or loss for the designated financial assets so that it reports the same overall amount that it would have reported in profit or loss if IAS 39 had been applied to those financial assets. However, because the insurer makes an offsetting adjustment to OCI, total comprehensive income is not affected. The carrying amounts of all financial assets are determined applying IFRS 9.

The adjustment to profit or loss for the designated financial assets addresses the additional accounting mismatches and volatility in profit or loss that may arise from applying IFRS 9 before applying the new insurance contracts Standard.

Eligibility for the overlay approach

The overlay approach is intended to address the additional accounting mismatches and volatility in profit or loss that may arise if an insurer applies IFRS 9 before applying the forthcoming insurance contracts Standard. To meet that objective:

a) an insurer may elect to apply the overlay approach only when it first applies IFRS 9; and

b) a financial asset is eligible for designation if, and only if, it meets both of the following criteria:

   i. it is measured at fair value through profit or loss (FVPL) applying IFRS 9 but would not have been measured at FVPL in its entirety applying IAS 39; and

   ii. it is not held in respect of an activity that is unconnected with contracts within the scope of IFRS 4.

Insurers may choose whether to apply the overlay approach, and to what extent. The availability of such a choice reduces comparability among insurers. However, the IASB decided not to require insurers to apply the overlay approach to all eligible financial assets. That is because there is no loss of information when an insurer applies the overlay approach to only some financial assets.

To mitigate the risk that an insurer could apply this approach selectively with the intention of managing reported profit or loss, the overlay approach includes the following conditions:

a) IFRS 9 is applied to designated financial assets, consistently with financial assets that are not designated, and the accompanying presentation and disclosure requirements make the effect of applying the overlay approach transparent.

b) an insurer may elect to apply the overlay approach only when it first applies IFRS 9.

c) an insurer must continue to apply the overlay approach to a designated financial asset until the asset is derecognised, unless the financial asset no longer meets the eligibility criterion described in paragraph b) ii. above or the insurer stops applying the overlay approach to all designated financial assets.

Presentation

The amount reclassified between profit or loss and OCI (overlay adjustment) is presented as a separate line item in profit or loss and in OCI, separately from other components of OCI. These presentation requirements are intended to make the overlay adjustment transparent, improve comparability with entities applying IFRS 9 without the overlay approach and provide users of financial statements with information about the effect on an insurer's financial results of applying IFRS 9 to designated financial assets before the forthcoming insurance contracts Standards.

Interaction with other requirements

The IASB observed that reclassifying an amount between profit or loss and OCI applying the overlay approach may have consequential effects for including other items in OCI (for example, income taxes). Nevertheless, it was decided that it was unnecessary to develop specific requirements for those consequential effects because other IFRSs contain the relevant requirements.

Transition

An insurer can apply the overlay approach only when it first applies IFRS 9. The approach to transition and comparative information for the overlay approach is consistent with the approach in IFRS 9. The insurer must apply the overlay approach retrospectively and is required to restate comparative information to reflect the overlay approach when that comparative information is restated applying IFRS 9, but otherwise is prohibited from doing so.

Temporary exemption from IFRS 9

The IASB observed that the application of the overlay approach would result in additional costs compared to applying IFRS 9 without the overlay approach or allowing insurers to continue to apply IAS 39. Therefore, it introduced a temporary exemption from IFRS 9 for a limited period for insurers whose activities are predominantly connected with insurance. An insurer applying the temporary exemption continues to apply IAS 39 rather than applying IFRS 9. Although the temporary exemption implies lower implementation costs, it presents the following disadvantages:

a) users of financial statements would not have the significantly improved information about financial instruments provided by applying IFRS 9; and
b) cross-sector comparability would be reduced.

Eligibility for the temporary exemption

The temporary exemption from IFRS 9 is applicable if, and only if:

a) the insurer has not previously applied IFRS 9; and
b) the activities of the insurer are predominantly connected with insurance, which is assessed on the basis of the following two criteria:
    i. the insurer has a significant amount of liabilities arising from contracts within the scope of IFRS 4; and
    ii. the percentage of the insurer's liabilities connected with insurance relative to all its liabilities meets a specified threshold.

Insurers must assess their eligibility for the temporary exemption from IFRS 9 at the reporting entity level. That is, an entity as a whole is assessed by considering all its activities. As a result, an insurer applies either IAS 39 or IFRS 9 to all its financial assets and financial liabilities.

Qualifying criteria

To determine whether an insurer is eligible for the temporary exemption from IFRS 9 the IASB decided to treat the following liabilities as being connected with insurance for the purposes of assessing whether an insurer's activities are predominantly connected with insurance:

a) non-derivative investment contract liabilities measured at FVPL applying IAS 39 (including those designated as at FVPL to which the insurer has applied the requirements in IFRS 9 for the presentation of gains and losses);
b) liabilities that arise because the insurer issues, or fulfils its obligations arising from: (i) contracts within the scope of IFRS 4 and (ii) non-derivative investment contracts measured at FVPL.

The IASB noted that an insurer may have liabilities such as those for salaries and other employment benefits for employees of the insurance activities. Those liabilities are to be treated as being connected with insurance for the purposes of the predominance test.

As mentioned above, the IASB decided that there should be a threshold that determines when an insurer's activities are considered to be predominantly connected with insurance. That determinative threshold is met when the percentage of the total carrying amount of an insurer's liabilities connected with insurance relative to the total carrying amount of all its liabilities is greater than 90 per cent. Nevertheless, an assessment based solely on this threshold has shortcomings and therefore the IASB decided that when an insurer narrowly fails to meet the threshold, the insurer is still able to qualify for the temporary exemption as long as more than 80 per cent of its liabilities are connected with insurance and it does not engage in a significant activity unconnected with insurance.

Thus, to achieve an appropriate balance between clearly identifying those insurers that qualify for the temporary exemption and creating 'bright lines', the IASB concluded that the insurer should consider both quantitative and qualitative factors to determine whether it has a significant activity unconnected with insurance.

The IASB acknowledged that determining 'significance' will require judgement but decided not to provide additional guidance on its meaning because this term is used in other IFRSs and is already applied in practice.

Assessment at the reporting entity level

The IASB concluded that a reporting entity would provide more understandable and useful information by accounting for its financial assets and financial liabilities applying either IFRS 9 or IAS 39 (i.e. if the temporary exemption from IFRS 9 applies at the reporting entity level). Therefore, the temporary exemption from IFRS 9 is only available if the entity as a whole qualifies by considering all of its activities.

Nonetheless, if a group fails to qualify for the temporary exemption from IFRS 9 because its activities are not predominately connected with insurance, then the group could provide additional information to explain more clearly the effects of applying IFRS 9 with IFRS 4.

Additionally, if an individual reporting entity undertakes activities predominately connected with insurance, and prepares separate or individual financial statements, it could apply the temporary exemption from IFRS 9 in those separate or individual financial statements, even though it is required to produce information using IFRS 9 for inclusion in the consolidated financial statements.

Initial assessment and reassessment of predominant activities

An entity has to assess whether its activities are predominantly connected with insurance at its annual reporting date (i.e. the end of its annual period) that immediately precedes 1 April 2016. This assessment date is intended to reduce uncertainty and provide adequate time for entities to implement IFRS 9 if they do not qualify for the temporary exemption. The 2015 ED proposed that an entity would assess whether it qualifies for the temporary exemption from IFRS 9 on the date that it would otherwise be required to initially apply IFRS 9 (the first day of the annual period beginning on or after 1 January 2018). However, respondents believed that entities would need to perform the assessment earlier than that proposed date because they would need adequate time to implement IFRS 9 if they did not qualify for the temporary exemption.

An entity that previously qualified for the temporary exemption from IFRS 9 is required to reassess whether its activities are predominantly connected with insurance at a subsequent annual reporting date if, and only if, there was a change in its activities (as described in paragraphs 20H-20I of IFRS 4) during the annual period that ended on that date (for example, the acquisition or disposal of a business line). The IASB considered that a change merely in the level of an entity's insurance liabilities relative to its total liabilities over time would not trigger a reassessment because such a change, in the absence of other events, would be unlikely to indicate a change in the entity's activities.

The entity's financial statements would reflect the effects of a change in its activities only after the change has been completed. Therefore, an entity performs the reassessment using the carrying amounts of its liabilities at the annual reporting date immediately following the completion of the change in its activities.

When an entity concludes, as a result of a reassessment, that its activities are no longer predominantly connected with insurance, the entity is permitted to continue to apply the temporary exemption from IFRS 9 only until the end of the annual period that began immediately after that reassessment. Nevertheless, the entity must apply IFRS 9 in annual periods beginning on or after 1 January 2021, which is the fixed expiry date of the temporary exemption.

Similarly, an entity that previously did not qualify for the temporary exemption from IFRS 9 and has not applied IFRS 9 is permitted to reassess its eligibility at a subsequent reporting date before 31 December 2018 (the effective date of IFRS 9) if, and only if, there was a change in the entity's activities (as described in paragraphs 20H-20I of IFRS 4).

Disclosure

The temporary exemption from IFRS 9 will delay the provision of better information by some insurers and reduce comparability among insurers and between insurers and other entities. To mitigate these disadvantages, the IASB decided that an insurer applying the temporary exemption must disclose information to enable users of financial statements to make some comparisons between insurers applying the temporary exemption and entities applying IFRS 9.

Thus, it was concluded that in order to balance the potential cost for preparers with improved comparability for users of financial statements and regulators the following disclosures are required:

a) fair value information for all financial assets, separated into groups that would identify a population that is similar to the population that would be separately disclosed as mandatorily measured at FVPL applying IFRS 9; and
b) credit risk information for a specific population of financial assets that is similar to the population to which the IFRS 9 expected credit loss requirements would apply.

Additionally, and in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors,* insurers are required to provide information about the expected effect of the Amendments to IFRS 4 before they are effective, including whether the insurer expects to apply the temporary exemption from IFRS 9.

Transition

The IASB noted that no special transition provisions are needed for the temporary exemption from IFRS 9 because:

a) the insurer would continue applying IAS 39 and start providing the disclosures required by the Amendments to IFRS 4, using the relevant provisions in IFRS 9 that are necessary to provide those disclosures; and
b) when applying IFRS 9 for the first time (after previously applying the temporary exemption) the insurer would apply the transition requirements in IFRS 9 and stop providing the required disclosures relating to the temporary exemption.

Fixed expiry date for the temporary exemption

The forthcoming insurance contract Standard will replace IFRS 4 and therefore, the temporary exemption from IFRS 9 will no longer exist when the insurer first applies that forthcoming Standard. However, the IASB decided that, even if the forthcoming insurance contract Standard is not effective by 1 January 2021, all insurers must apply IFRS 9 for annual periods beginning on or after 1 January 2021.

In contrast, the IASB rejected a fixed expiry date for the overlay approach. Unlike insurers applying the temporary exemption from IFRS 9, insurers applying the overlay approach will provide the improved financial instrument information required by IFRS 9 and information about the effects on designated assets of moving from IAS 39 to IFRS 9.

Temporary exemption from specific requirements in IAS 28

When an entity applies the equity method, paragraphs 35-36 of IAS 28 *Investments in Associates and Joint Ventures* require the entity to adjust its associate's or joint venture's accounting policies to conform them to the entity's accounting policies. The 2015 ED did not propose any relief from this requirement. Nevertheless, as a result of the feedback received the IASB decided that:

a) an entity that applies IFRS 9 would be permitted, but not required, to retain the IAS 39 accounting used by any associate or joint venture that applies the temporary exemption from IFRS 9 in its financial statements;
b) an entity that applies the temporary exemption from IFRS 9 would be permitted, but not required, to retain the IFRS 9 accounting used by any associate or joint venture in its financial statements; and
c) these reliefs would be available separately for each associate or joint venture.

The IASB concluded that similar reliefs are not needed for the overlay approach because that approach is applied on an instrument-by-instrument basis, that is, an entity need not apply the overlay approach to all eligible financial assets. Accordingly, when applying the equity method, the entity could retain (or modify) the overlay approach applied by an associate or joint venture or retain the associate's or joint venture's full IFRS 9 accounting.

First-time adopter

As a result of the concerns raised by some interested parties the IASB decided to permit first-time adopters to apply the overlay approach or the temporary exemption from IFRS 9 consistently with existing IFRS preparers if, and only if, those first-time adopters meet the same criteria.

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