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IASB proposes amendments to IFRS 4 to address concerns about the different effective dates of IFRS 9 and the new insurance contracts Standard that will replace IFRS 4

Why are the amendments being proposed?

The amendments are intended to alleviate the concerns of the insurance industry over the different effective dates of the financial instruments and the new insurance contracts Standards. IFRS 9 Financial Instruments would apply for annual periods beginning on or after 1 January 2018, whereas the new insurance Standard, when published, would allow for implementation approximately three years from the date of publication which may translate in an effective date that would be at least two years later than when IFRS 9 becomes effective.

The volume and cost of changes in a short period of time, the difficulty in explaining the volatility in the financial statements following the adoption of IFRS 9 without the parallel adoption of the new insurance contracts Standard and the difficulty in applying the classification and measurement criteria in IFRS 9 ahead of the new insurance contracts Standard were the concerns cited by preparers.

In proposing these amendments, the IASB intended to address some of these issues while balancing the benefits of comparability and the significant accounting improvements introduced by a timely implementation of IFRS 9.

What are the proposed amendments?

Option to defer the application of IFRS 9

The exposure draft proposes an option for entities that 'predominantly' issue contracts within the scope of IFRS 4 and have not previously applied any version of IFRS 9 to defer the initial application of IFRS 9 until the application of the new insurance contracts Standard or until annual reporting periods beginning on or after 1 January 2021 at the latest.

Such entities would, however, be permitted to only apply the requirement in IFRS 9 to present in other comprehensive income the gains and losses on liabilities designated as at FVTPL that arise from changes in the entity's own credit risk. Entities predominantly issuing insurance contracts that have previously applied only this requirement of IFRS 9 would also be eligible for the deferral option.

To qualify for the exemption the reporting entity would need to determine whether its 'predominant activity' is issuing contracts within the scope of IFRS 4 on the date that the entity would otherwise be required to apply IFRS 9. This assessment is based on the ratio of the entity's liabilities arising from contracts within the scope of IFRS 4 (insurance and certain investment contracts) to its total liabilities. The assessment is proposed to be done at the reporting entity level (whether that is a single legal entity or a consolidated group). If the predominance condition exists, the entity would have the option to continue to apply IAS 39 Financial Instruments: Recognition and Measurement to all its financial instruments, including assessing financial assets for impairment using the incurred loss model.

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In drafting the exposure draft, the IASB placed more weight on preventing the deferral of IFRS 9 for insurance groups with significant banking or asset management liabilities than on capturing the whole population of insurers. While there are no quantitative thresholds, the basis for conclusions on the exposure draft states that a 75 per cent ratio of insurance to total liabilities would not meet the predominance condition.

Observations

The ratio of insurance to total liabilities used to assess 'predominance' is sensitive to the balances existing on a particular date. The proposed assessment is based on a single ratio that, while simple to apply, would make it difficult to pass the test for many insurers for a number of reasons. For example the ratio does not take into account the degree to which the entity's total liabilities are affected by its funding structure (e.g. the use of subordinated capital classified as a financial liability instead of equity capital would dilute the predominance condition for that insurer) or the speed of settlement of the insurance liabilities compared to other liabilities or other insurers (e.g. insurance liabilities may not produce a high ratio if the insurer settles claims from its insurance contracts faster than its other liabilities).

Within a group that does not meet the deferral exemption criteria there may well be a 'predominantly insurance' subsidiary. If the option to defer the application of IFRS 9 is chosen at the individual entity level, group level adjustments would need to be made.

After the initial assessment, the predominance condition would be reassessed at the end of each subsequent reporting period only if there were a demonstrable change in the corporate structure of the entity. An entity no longer meeting the predominance criteria would have to apply IFRS 9 from the beginning of its next annual reporting period. The exposure draft also proposes to allow entities to choose to stop deferring the application of IFRS 9 from the beginning of any subsequent annual reporting period.

To aid comparability, entities applying the exemption would need to make extensive disclosures requiring at least the execution of the classification exercise required under IFRS 9. However, these disclosures would not require the presentation of the impairment losses under the new IFRS 9 requirements.

Option to present changes in fair value of qualifying financial assets using the "overlay approach"

To address the fact that a number of insurers would not be able to defer the application of IFRS 9, the exposure draft offers to all entities issuing contracts within the scope of IFRS 4 an option to present in other comprehensive income some of the fair value gains and losses from qualifying financial assets that would otherwise have been recognised in profit or loss for the first time on adoption of IFRS 9. The option is proposed to be available only on initial application of IFRS 9 or on first application after having previously applied only the IFRS 9 requirements for presentation of gains and losses on liabilities designated as at FVTPL.

Qualifying financial assets are those designated as relating to insurance contracts (or investment contracts within the scope of IFRS 4) and required to be measured at FVTPL by IFRS 9 but not by IAS 39.

Under this proposal, the difference between the amounts presented in profit or loss under IFRS 9 and the amounts that would have been so presented under IAS 39 would be reclassified from profit or loss to other comprehensive income.

Observations

The overlay approach applies to financial assets related to insurance contracts that are measured at FVTPL only as a result of applying IFRS 9. In other words, the IASB accepted that IFRSs can now define assets backing insurance liabilities and uses this concept for the calculation of the overlay adjustment. The balances of financial assets identified as in scope of the overlay approach would need to be tracked at each reporting date. This would mean creating and maintaining two sets of accounting records (under IAS 39 and IFRS 9) for each of the qualifying financial assets designated to generate the overlay adjustment. The relationship between the insurance contracts and the financial assets would also need to be reviewed over time.

The exposure draft permits the overlay approach to be applied only on the initial application of IFRS 9. However, if the entity applies the overlay approach, it may newly designate a previously recognised financial asset as relating to contracts within the scope of IFRS 4 (and, thus, include it in the calculation of the overlay adjustment) if there has been a change in the relationship since the original application of IFRS 9. The fair value of the newly designated financial asset at the date of designation would be its new amortised cost amount for the purposes of this calculation. The gain or loss recognised in profit or loss from the designation date to the next reporting date would then be reclassified to other comprehensive income.

De-designation of financial assets from qualifying for the overlay approach is proposed only if there is a change in the relationship between the financial assets and the contracts within the scope of IFRS 4. The gains and losses deferred in other comprehensive income on de-designated financial assets would then be recycled to profit or loss and these assets would, from the date of de-designation, be recognised and measured at FVTPL without generating an overlay adjustment.

An entity could change its accounting policy and stop applying the overlay approach at the beginning of any annual reporting period in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. Similarly an entity would stop applying the overlay approach if it no longer issued contacts within the scope of IFRS 4. Once use of the overlay approach ceases, it could not subsequently be resumed. However, a temporary lack of qualifying assets would not result in a requirement to cease applying the overlay approach.

Observations

Application of the overlay approach, while proposed to be an accounting policy choice, would be available for application to individual financial assets. Conversely, discontinuation of the overlay approach would affect all financial assets so designated. Individual financial assets can only be de-designated if there is a change in their relationship with contracts within the scope of IFRS 4.

The exposure draft is not prescriptive on how best to present on the face of the financial statements the impact of applying the reclassification adjustment produced by the overlay approach. The total amount of reclassifications from profit or loss to other comprehensive income would be presented on the face of the financial statements, but the effect on the individual line items could be presented either on the face or in the notes. Additional disclosures are proposed to explain how reclassifications are calculated and to allow comparability over time for assets that have been newly designated or de-designated to be part of the calculations for the reclassification adjustment under the overlay approach.

Observations

Entities applying the overlay approach would need to consider how best to present the overlay reclassification adjustments on the face of the financial statements and in the notes.

Transition and comment period

The IASB considered the proposed amendments as a temporary relief measure for entities already applying IAS 39 and IFRS 4, recognising that the timely implementation of IFRS 9 remains imperative. As a result, the amendments proposed in the ED would not apply to first time adopters of IFRS, both because IFRS 9 would be the most recent version of the financial instruments Standard and because of the need otherwise to track two sets of data under two different Standards in the same way as existing IFRS reporting entities.

The proposed deferral approach would be effective for annual periods beginning on or after 1 January 2018. The existing IFRS 9 transition provisions would apply to entities that choose or are required to stop applying the deferral approach.

The proposed overlay approach amendments would be effective retrospectively when the entity first applies IFRS 9. For qualifying financial assets the opening balance in other comprehensive income would be adjusted for the difference between the fair value determined by applying IFRS 9 and the carrying amount under IAS 39. The restatement of comparatives would follow the IFRS 9 treatment, with permission to restate comparatives to reflect the overlay approach only if the entity restates comparatives under IFRS 9.

Observations

Essentially, reporting entities with contracts within the scope of IFRS 4 could have three different accounting models for financial assets:

• continuing to apply IAS 39 for those reporting entities meeting the predominance condition;

• applying IFRS 9 with the overlay approach; and

• applying IFRS 9 in full with no overlay adjustment.

The IASB requested comments on the proposed amendments to IFRS 4 by 8 February 2016.