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IASB issued an amendment to IFRS 4 Insurance Contracts to address concerns about the different effective dates of IFRS 9 and the new insurance contracts Standard that will replace IFRS 4

Published on:
September, 2016

Introduction

IFRS 9 Financial Instruments and the upcoming insurance contracts Standard that will replace IFRS 4 Insurance Contracts are both expected to result in major accounting changes for most insurers and entities issuing financial instruments with discretionary participating features. The parallel application of these standards was always seen by the IASB as a desirable outcome to avoid the application of IFRS 9 classification and measurement criteria to financial assets without at the same time applying the new insurance standard to associated liabilities. This would have avoided short -term accounting volatility from a greater proportion of financial assets being reported at FVTPL in the financial statements as well as additional costs of transitioning separately to two major new standards.

However, as IFRS 9 was finalised in July 2014 it became apparent that the two standards will potentially have significantly different effective dates. IFRS 9 is effective for annual periods beginning on or after 1 January 2018.

The new insurance Standard, when published, is expected to have a three year implementation window from the date of publication, which would translate into an effective date of 1 January 2020, at the earliest. To address preparers' concerns, while ensuring that IFRS 9 is implemented on a timely basis, the IASB has amended IFRS 4 to provide two voluntary approaches to mitigate the issues arising for insurers as a result of the effective date of IFRS 9 falling before that of the upcoming insurance contracts Standard.

The amendment:

- provides some entities with a temporary exemption from application of IFRS 9; and
- gives all entities with insurance contracts the option, following full adoption of IFRS 9, to present changes in fair value on qualifying designated financial assets in other comprehensive income (OCI) instead of profit or loss (referred to as the "overlay approach").

The temporary exemption from applying IFRS 9

Temporary deferral of IFRS 9 is available only to insurers whose activities are predominantly connected with insurance, with predominance' assessed based on a defined criterion. To qualify the entity must not have already applied any version of IFRS 9, except for the requirement to present in OCI changes in credit risk on liabilities designated as at fair value through profit or loss.

The deferral is temporary as all entities must apply IFRS 9 at the earlier of the application of the new insurance Standard or periods beginning 1 January 2021 (this fixed date is known as "the sunset clause").

The assessment of whether the entity qualifies for the deferral is made at the reporting entity level and at a single point in time. It is based on its annual reporting date immediately preceding 1 April 2016 (e.g. 31

December 2015 for calendar year end reporting periods), so that preparers could assess whether they qualify for the deferral before the transition date for IFRS 9. This criterion is then reassessed only if here has been a significant change to the entity’s activities.

What is the predominance criterion?

The criterion is based on a ratio between certain liabilities (the numerator) and the total liabilities reported on the statement of financial position (the denominator) for the reporting entity.

The numerator includes a number of liabilities:

- liabilities arising from contracts within the scope of IFRS 4 as including insurance liabilities together with any unbundled embedded derivatives or deposit components. The entity must assess whether the carrying amount of these liabilities is significant when compared to the total liabilities’ carrying amount. This is a precondition to calculate the predominance ratio.
- provided the liabilities arising from IFRS 4 contracts are significant, the entity must include in the numerator thearrying amount of liabilities connected with insurance. These include:

a) liabilities arising from contracts (as above);

b) non-derivative investment contracts measured at FVTPL; and

c) liabilities that arise because the insurer issues or fulfils obligations arising from (a) or (b).

The category of liabilities arising from fulfilling obligations (item c) above) following from issuing insurance contracts or non-derivative investment contracts measured at FVTPL is not defined. It is intended to include relevant employment and tax liabilities, debt issued to meet regulatory insurance capital requirements, derivative liabilities mitigating risks arising from insurance contracts and from assets backing those contracts, among others.

The entity must then calculate a ratio of those ‘liabilities connected with insurance’ compared to the total carrying amount of its liabilities. A ratio greater than 90% would mean that entity qualifies for the temporary exemption. A ratio of 80% or less would not qualify for the temporary exemption. A ratio of between 80% and 90% would mean that the entity only qualifies for the temporary exemption if it has no other significant activity unconnected with insurance. In assessing whether there is a significant non-insurance activity, the entity would only look to activities generating income and expenses and would consider both qualitative and quantitative factors, for example, the entity’s industry classification.

Observations

The IASB has intentionally broadened the criteria from those proposed in the exposure draft in response to feedback. However, the option of deferral is still intended to be available only to a specific population of entities. There is a degree of judgement in deciding which liabilities are connected with insurance. The entities would also need to exercise judgement in determining the significance of liabilities arising from IFRS 4 contracts and the significance of non-insurance activities if the predominance ratio falls between 80 and 90%.

Can entities taking the option of deferral subsequently choose to start applying IFRS 9?

Entities qualifying for, and choosing to take, the temporary exemption can start voluntarily applying IFRS 9 from the beginning of any subsequent annual period. Once IFRS 9 has been applied, an entity cannot revert to applying IAS 39. Additionally, entities no longer meeting the deferral criteria because of a significant change in their activities will have one annual period before they would be required to apply IFRS 9. For example, a calendar-year reporting entity assessed as no longer an entity with predominant insurance activities at 31 December 2018, would be required to apply IFRS 9 from 1 January 2020.

All entities with IFRS 4 contracts that are required to apply IFRS 9 would still be able to apply the overlay approach (see below) until the new insurance Standard becomes effective.

Is the temporary exemption available to first-time adopters of IFRS?

In a change to the exposure draft, first-time adopters can apply the temporary exemption, provided they have not already applied IFRS 9 (other than applying a version of IFRS 9 requiring presentation of changes in credit risk of liabilities designated at FVTPL in OCI). In assessing the predominance criterion, a first-time adopter would look to the carrying amounts determined in the application of IFRSs at its date of assessment. The date of the assessment would be the last annual reporting date before 1 April 2016, or a subsequent annual reporting date if there has been a significant change in the entity's activities.

Disclosure

There are numerous disclosure requirements explaining how the entity qualified for the temporary exemption and allowing comparison between insurers applying IFRS 9 and those that are not.

Observations

Insurers qualifying for the temporary exemption will still need to look to the requirements of IFRS 9 in order to comply with a number of disclosure requirements. However, this will not require the implementation of an IFRS 9 compliant credit impairment model ahead of IFRS 9 full implementation.

The overlay approach

The overlay approach is available to all entities issuing contracts within the scope of IFRS 4, when they apply IFRS 9. It modifies the presentation of fair value gains and losses on qualifying designated financial assets, removing these gains and losses from profit or loss and presenting them in OCI instead.

To qualify for inclusion in the overlay approach, assets must be measured at FVTPL under IFRS 9 when they would not have been so measured under IAS 39. Qualifying assets must also be specifically designated as being subject to overlay and must not be held in respect of activities not connected with IFRS 4 contracts. The designation needs to be made when the entity first applies IFRS 9 (other than applying a version of IFRS 9 requiring presentation of changes in credit risk of liabilities designated at FVTPL in OCI), and thereafter on initial recognition of an asset. The designation can be made on an asset-by-asset basis. There are specific requirements for de-designations.

The effect of the overlay approach is to present in profit or loss the amount that would have resulted from application of IAS 39 to the asset, with the difference between that amount and the fair value movement recorded under IFRS 9 recognised in OCI.

There are numerous disclosure requirements to ensure that the users can see the overall effect of the reclassifications on profit or loss and OCI and the individual line items affected. These include the reasons for the designations and reclassifications, the IFRS 9 and IAS 39 carrying amounts of assets affected and other disclosures.

Observations

Entities applying the overlay approach will need to exercise judgement in deciding which of their financials assets are connected with insurance activities. Once designated, these financial assets will need to be tracked, as their measurement in the statement of financial position will follow IFRS 9, but their presentation in profit or loss will follow IAS 39, with the difference recorded in OCI, and disclosure reconciling these balances would be required.

Can the overlay approach be discontinued?

Once designated, the overlay approach will normally be applied to an asset until its derecognition. However, assets will be de-designated if they stop qualifying for the overlay approach because they cease to be held in respect of activities connected with contracts within the scope of IFRS 4 (for example, if they are transferred to a banking operation, or if the entity ceases to be an insurer). On de-designation, amounts previously recognised in OCI will be reclassified to profit or loss.

Further, an entity may voluntarily choose to stop applying the overlay approach, provided it stops applying it to all of its financial assets. This would be a change in accounting policy under IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors with retrospective application.

IFRS first-time adopters

The overlay approach is available to IFRS first-time adopters. The comparatives for the overlay approach may only be restated if the entity restates comparatives on application of IFRS 9.

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