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Insurance Accounting Alert

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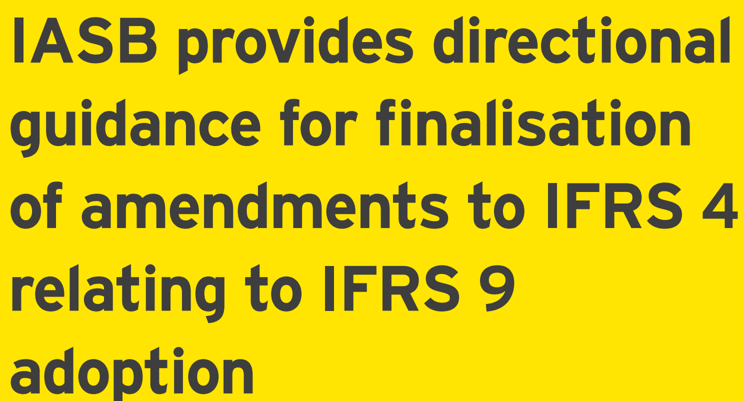

IASB provides directional guidance for finalisation of amendments to IFRS 4 relating to IFRS 9 adoption

What you need to know

The IASB discussed feedback received on the proposals in the December 2015 ED to amend existing IFRS 4 relating to adoption of IFRS 9. The Board confirmed, consistent with the proposals, key directions for the staff to follow as they finalise the amendments to:

- Provide an optional temporary exemption from applying IFRS 9 for qualifying entities.
- Determine eligibility for this exemption at the reporting entity level only and to include a fixed expiry date for this exemption
- Provide an optional overlay approach

Overview

During its March meeting, the International Accounting Standards Board (IASB or the Board) commenced redeliberations on the exposure draft (the ED) Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts* (Amendments to IFRS 4). The ED proposed to amend existing IFRS 4 *Insurance Contracts* (existing IFRS 4) to allow entities issuing insurance contracts to mitigate certain effects of applying IFRS 9 together with the existing IFRS 4 before the new insurance contracts standard (IFRS 4 Phase II) becomes effective.

The Board discussed the feedback and comment letters received on the proposals in the ED. The staff also asked the Board to provide directional decisions on how it should move ahead with finalising the proposals.

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 and papers on the insurance contracts project for the February meeting. These contain a summary of the progress on the project to date, an overview of the tentative decisions made, and the proposed model for insurance contracts: www.ifrs.org/Meetings/MeetingDocs/IASB/2016/February/AP02B-Insurance-Contracts.pdf
- The cover note for the Board's papers on insurance for the March meeting which contains the background to the December 2015 ED: www.ifrs.org/Meetings/MeetingDocs/IASB/2016/March/AP14-Insurance-and-IFRS-9.pdf
- Further information on the project and the proposed model is available at: www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Insurance-Contracts.aspx

Summary of feedback

The Staff presented an extensive summary of the feedback received in 96 comment letters on the proposals in the ED and from outreach performed by the IASB during the comment letter period. The staff also provided the Board with a specific analysis of the feedback from an extensive outreach exercise with users of financial statements.

Comment letters

Key themes from the summary of comment letters are outlined below:

Most respondents thought that the issues arising from applying IFRS 9 in advance of the new insurance contracts standard (IFRS 4 Phase II) needed to be addressed, given the strong interaction between accounting for insurance liabilities and the financial assets backing those liabilities, the associated additional volatility in profit or loss from accounting mismatches caused by the application of IFRS 9 before IFRS 4 Phase II, and the potential cost implications.

Most constituents were in favour of providing a temporary exemption from the adoption of IFRS 9 in 2018 (the deferral approach) and also providing the alternative overlay approach.[1]

The ED proposed that the adjustment would only apply to financial assets relating to contracts in scope of IFRS 4 and classified as fair value through profit or loss (FVPL) under IFRS 9 but not FVPL under IAS 39 *Financial Instruments: Recognition and Measurement*. Many constituents asked for more guidance on the designation of financial assets that would qualify for the overlay approach.

Many respondents also commented that the ED provided too many options for disaggregating the overlay adjustment in the Statement of Comprehensive Income.

A majority of respondents wanted the predominance criteria for the deferral approach to be amended in order to allow more entities that they consider to be insurers to qualify.[2] Mixed views were expressed on whether the predominance criteria should be quantitative or a combination of quantitative and qualitative criteria, such as presuming that entities regulated as insurers are predominantly insurers.

Regulators (including global and European securities regulators, global and European banking regulators and the European Insurance and Occupational Pensions Authority oppose the deferral approach being applied below reporting entity level. In the view of these regulators, not going below the reporting entity level would ensure that all the financial assets in the consolidated financial statements of an eligible reporting entity choosing deferral will continue to be accounted for under IAS 39. For those reporting entities not eligible for the deferral approach, all financial assets in the consolidated financial statements will be accounted under IFRS 9. Subsidiaries would assess eligibility criteria at their reporting entity level for their own financial statements.

Many preparers and other constituents (other than users and regulators) were in favour of deferral below reporting entity level, or a combination of deferral at reporting entity and below (the so-called "waterfall approach") in order to allow insurers in conglomerates to defer IFRS 9, rather than have to determine eligibility on the basis of the consolidated financial statements of the conglomerate.

Most constituents agreed that both the overlay and deferral approaches should be optional, allowing entities to apply IFRS 9 in full given it is agreed to be an improvement on IAS 39.

There was a range of views on mandating a fixed expiry date for the deferral approach.

Some respondents raised additional issues with suggestions such as:

a) To allow deferral and overlay for first-time adopters (this issue was raised in Italy and Singapore)

b) To allow investments in insurers accounted for by a parent using the equity method to have a carrying amount derived from IAS 39 (if they qualify for deferral in standalone financial statements) even if the group does not qualify for deferral, i.e., to allow non-uniform accounting policies in group financial statements

User outreach

The IASB also conducted extensive outreach with around 100 users of financial statements.

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[1] 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 the adoption of IFRS 4 Phase II, and recognise those impacts in Other Comprehensive Income temporarily.

[2] Under the proposal the deferral approach can only be applied by a reporting entity if a 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. The Basis for Conclusions of the ED includes an example that indicates a proportion of 75% would not result in the insurance activities being predominant.

Key themes from this outreach are outlined below:

Many users did not believe that increased temporary volatility would make financial analysis more difficult as they use other metrics in addition to profit or loss, and volatility already exists, but other users in Europe and Asia who follow the insurance industry, stated that increased volatility would be unhelpful and make the insurance industry appear more uncertain and less attractive to investors.

Many users did not think that a solution was needed, weighing up concerns about the different effective dates of IFRS 9 and IFRS 4 Phase II with the lack of comparability that would be created. If a solution had to be provided, they did not want to have two options – preferring only one approach that should be mandatory to avoid confusion.

Most users of financial statements are opposed to the deferral of IFRS 9, in particular they oppose deferral below reporting entity level, arguing it introduces lack of comparability, creates accounting arbitrage and reduces information content. Those who supported deferral were mainly insurance specialists focused on the insurance sector, as opposed to users who follow financial conglomerates and entities with non-insurance activities. Some users suggested amendments to widen the eligibility criteria for the deferral approach to allow more comparability within the insurance sector by capturing entities they consider as being within the insurance sector.

Most users would more readily accept the overlay approach as an acceptable compromise that provides comparable information and removes volatility in a transparent way.

If a deferral were to be allowed, users were in favour of a fixed expiry date of 1 January 2021 to ensure that it is only a temporary exemption. Some urged the Board to complete the IFRS 4 Phase II as soon as possible to deal with the significant current user concerns related to the lack of transparency and comparability of insurance contract liabilities.

Board discussion

The Board carefully weighed up the wide ranging feedback and took into consideration the points raised before providing direction to the staff. They were conscious of having to balance the differing needs and views of constituents.

Some Board members noted that, based on the feedback received, the overlay approach did not appear popular with preparers. However, these Board members questioned some of the concerns raised about the costs of implementing the overlay approach. They recognised that there would be additional cost involved, but suggested that this may have been overplayed in comments to state a stronger case for the preferred option of deferral.

When considering whether deferral should be at the reporting entity level or below, the Board concluded, as in previous meetings, that application below the reporting entity level would be challenging and overly complex. One Board member pointed out that a financial conglomerate that does not qualify for deferral could use existing segmental reporting requirements to provide information on its insurance subsidiary to users to facilitate a comparison of its insurance business with insurers that do qualify for deferral (i.e., it could present the insurance segment under IAS 39 for segmental reporting). The Board member noted that the inverse would apply to a financial conglomerate that would qualify for deferral (i.e., the conglomerate could present the banking segment under IFRS 9 for segmental reporting).

One Board member continued to voice concerns about any deferral of IFRS 9, with a particular concern not to lose the additional valuable information on expected credit losses that it introduces, given that insurers may have huge loan portfolio assets on their balance sheets. He remained unconvinced by the arguments for deferral and asked other Board members to state their rationale for still supporting it in the light of the feedback that so many users of financial instruments oppose it. He expressed the view that the additional costs of implementing IFRS 9 in advance of IFRS 4 is not a valid argument, given that most costs will have to be incurred eventually when IFRS 9 is implemented, so the costs would only be deferred.

In response, other Board members stated it was not purely the cost argument that influenced their decision, but also the fact that there was not a unanimous or uniform view within or between groups of constituents on the deferral approach, and that some regulators and standard setters did support it. These Board members added they were aware that a deferral approach may not be what users prefer, but the range of views expressed by constituents need to be weighed up. These Board members also felt that as the Board had decided to have different effective dates for IFRS 9 and IFRS 4 Phase II, it needed to provide a temporary solution.

The Chairman also commented that IFRS 4 Phase II, together with IFRS 9, will represent a massive reform of and improvement on existing insurance accounting. The Chairman added that, in his view, the Board should be flexible in the transition period in order to help people reach the end goal.

Direction for completion of the amendments to IFRS 4

Having considered the feedback, the Board confirmed that staff should follow the key directions set out below, consistent with the staff proposal and in line with the ED, in finalising the amendments to the standard:

- Provide a temporary exemption from applying IFRS 9 for qualifying entities (11 of the 14 Board members were in favour of this)
- Determine eligibility for the temporary exemption at the reporting entity level only (i.e., eligibility is determined by considering all of the activities of the reporting entity, exemption cannot apply to some parts of an entity but not others, and the reporting entity applies only one standard, either IFRS 9 or IAS 39, to all of its financial instruments in its financial statements) (13 Board members were in favour)

- Include a fixed expiry date for the temporary exemption (13 Board members were in favour)
- Provide an overlay approach (13 Board members were in favour)
- The temporary exemption from applying IFRS 9 and the overlay approach to be optional (all 14 Board members in favour)

Some Board members mentioned during the meeting the possibility of widening the predominance criteria of eligibility for the deferral approach. No formal proposals were made or decisions taken on this matter at this point as the Board will discuss this topic during one of its forthcoming meetings.

The staff also presented its project plan for the redeliberations of the proposed amendments, with the aim to issue final amendments to the existing IFRS 4 in September 2016.

How we see it

When the IASB initially voted on the proposals to allow the deferral and overlay approaches, a significant minority were opposed. After this latest vote, a larger majority of the Board were in favour (11 of the 14 Board members). These Board members appear to have been swayed by the feedback received on the ED from constituents and by the IASB's decisions to include a fixed expiry date for the exemption and not to assess eligibility for that exemption below the reporting entity level.

The staff's project plan reflects a strong determination to finalise the amendments expeditiously. Based on the feedback received in the comment letters, it is expected that at a future meeting the Board will reconsider the eligibility criteria for the temporary exemption, determined by when an entity's activities are predominantly issuing contracts within the scope of IFRS 4, in order to make this exemption more widely applicable.

What's next?

With the direction provided by the Board in the March meeting, the staff will focus on their project plan and bring back further papers to the April and May Board meetings, including, for example, the topics of the eligibility for the temporary exemption and disclosures, with the aim to issue final amendments to the existing IFRS 4 in September 2016.

In parallel, following direction in the February meeting, the staff is working on the balloting process for IFRS 4 Phase II in order to produce a draft insurance contracts standard for a Board ballot. The process is expected to take up the remainder of 2016, and, there will be ongoing communication and targeted consultation during this period. The Board will decide on the effective date of the new standard in due course.

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