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Insurance Accounting Alert

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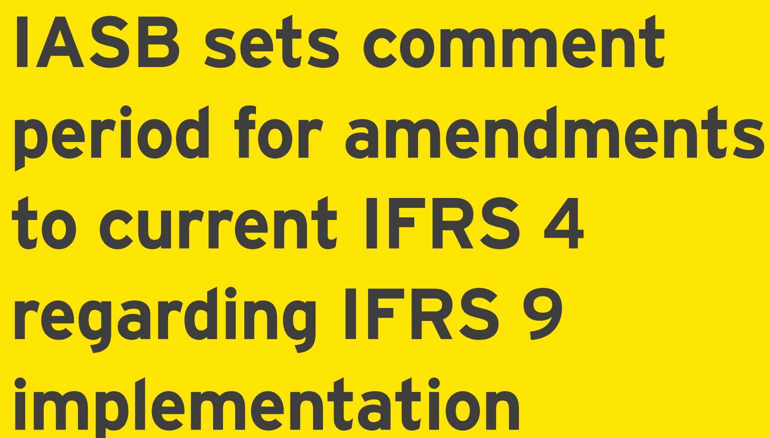

IASB sets comment period for amendments to current IFRS 4 regarding IFRS 9 implementation

What you need to know

- The IASB has set the comment period at 60 days for the IFRS 4 ED of proposed changes to existing IFRS 4 for the "deferral" and "overlay" approaches to IFRS 9 implementation. (These amendments aim to address concerns over the different effective dates of IFRS 9 and a new insurance contracts standard).
- The IASB decided that:
  - Insurers who adopt IFRS 9 before the new insurance contract standard will have the option to reassess the business model for classification and measurement of financial assets on application of IFRS 4 Phase II
  - Entities will neither be required nor permitted to use the "mirroring approach" referred to in the previous IFRS 4 ED
  - The proposed presentation and disclosure requirements in IFRS 4 Phase II should be amended to reflect the impact of recent decisions.

Overview

During its October meeting, the International Accounting Standards Board (IASB or the Board) continued its discussions on the new insurance contracts standard (IFRS 4 Phase II). It discussed further the proposed amendments to existing IFRS 4 *Insurance Contracts* (IFRS 4) to address concerns over the different effective date of IFRS 9 *Financial Instruments* (IFRS 9) and IFRS 4 Phase II.

The IASB also discussed whether to retain the "mirroring approach" proposed in the Exposure Draft *Insurance Contracts ED/2013/7* (2013 ED) for some types of participating contracts and it reviewed the presentation and disclosure requirements proposed in the 2013 ED.

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 for the Insurance Board papers for the October meeting which contains a summary of progress so far: www.ifrs.org/Meetings/MeetingDocs/IASB/2015/October/AP02-Insurance-contracts.pdf
- Further information on the project and the proposed model: www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Insurance-Contracts.aspx

Comment period for exposure draft on IFRS 4 amendments regarding IFRS 9 implementation

At the October meeting, the IASB agreed to set the comment period for the forthcoming exposure draft on IFRS 4 amendments regarding IFRS 9 implementation (IFRS 4 ED) at 60 days. The IFRS 4 ED, which the staff plans to issue in December 2015, will ask for comments on the proposed option in the existing IFRS 4 for insurers to either:

(i) defer the implementation of IFRS 9 until the earlier of the effective date of a new insurance standard and 2021 ("deferral approach"); or

(ii) benefit from options to remove from profit and loss some of the accounting mismatches and temporary volatility that could arise if IFRS 9 is implemented before the new insurance contracts standard ("overlay approach").

The Board agreed on a 60 day comment period to strike a balance between the urgent need to confirm any amendments in time for application and allowing sufficient time for consideration and comment on the proposals. Staff noted that entities should not need an extensive implementation period because the overlay approach builds on information already reported in accordance with IAS 39, and the deferral approach is a temporary exemption from IFRS 9 requirements other than specific disclosures which will still be required on full implementation of IFRS 9.

All thirteen IASB members present agreed with this decision (one IASB member was absent).

Further proposals on the scope of ED to amend IFRS 4 regarding IFRS 9 implementation

These deferral and overlay approach amendments seek to address concerns over additional temporary volatility that may arise in profit or loss if IFRS 9 is applied before IFRS 4 Phase II. They also address concerns over the additional cost and effort for preparers and users of financial statements as a result of applying two consecutive sets of major accounting changes in a short period of time.[1]

During the October meeting, the Board tentatively decided that the deferral and overlay approaches will only be available to a company if it had not previously applied IFRS 9. This means that companies adopting IFRS for the first time on or after 1 January 2018 (i.e., the effective date of IFRS 9), will not be able to use either the deferral approach or the overlay approach.

All fourteen IASB members agreed with this decision

At the September meeting, the IASB decided that the deferral approach would apply only to reporting entities with a predominant part of their business devoted to the activity of issuing contracts within the scope of IFRS 4. Some Board members raised questions about the impact upon insurers with a large percentage of investment contract liabilities outside the scope of IFRS 4, and also on conglomerate financial institutions. The IASB expressed the view that "predominant" should represent a high hurdle, indicating that this was likely to be more than two thirds of total liabilities. During the October meeting, the staff noted its intention to indicate in the forthcoming ED that an entity in which 75% of its liabilities arose from contracts within the scope of IFRS 4 would not meet the predominance condition.

Classification and measurement of financial assets on transition to IFRS 4 Phase II

The IASB previously agreed to allow insurers that initially apply IFRS 9 before they apply IFRS 4 Phase II to reassess the business model for classification and measurement of financial assets under IFRS 9 on the application of the new insurance contracts standard. This was in response to concerns over having to apply the classification and measurement requirements in IFRS 9 before the effects of IFRS 4 Phase II could be fully evaluated.

[1] Refer to our September *Insurance Accounting Alert* 'IFRS 9 deferred for insurance entities; further progress on participating contracts model' for further background.

At the October meeting, the IASB decided that reassessment would be optional rather than mandatory and that it would apply only to financial assets that an entity designates as related to contracts within the scope of IFRS 4 or IFRS 4 Phase II, consistent with the designation approach that the Board adopted for the overlay approach. The Board agreed with the staff recommendation that the reassessment of the business model for managing financial assets, the designation and de-designation of financial assets under the fair value option (FVO) and the other comprehensive income (OCI) presentation election for investments in equity instruments should be based on the facts and circumstances that exist on initial application of IFRS 4 Phase II at the latest period presented. The resulting classification should be applied retrospectively.

Entities that have previously applied IFRS 9 will be permitted (but not required) to restate comparative information about financial assets, provided this is possible without hindsight. This is in line with the requirements in IFRS 9, which does not require restatement and only allows it if this can be done without the benefit of hindsight. The Board noted that restatement of the business model on application of IFRS 4 Phase II should not be inconsistent with the requirements of IFRS 9.

The Board tentatively agreed that entities applying this transition relief would need to provide disclosures on:

- The policy for designating financial assets to which the relief is applied
- Changes in classification and measurement on transition date, including:
  - The measurement category and carrying amounts both before and after application of IFRS 4 Phase II
  - The amount of any financial assets previously (but no longer) designated under the fair value option
  - Qualitative information to enable users to understand how an entity applied the transitional provisions

Some Board members questioned whether such disclosures would just be boiler plate as they would all use the adoption of IFRS 4 Phase II as their main explanation, but other members emphasised the importance of explaining the facts and circumstances of adoption of the new insurance contracts standard and any impact on managing assets differently to avoid accounting mismatches. Otherwise, this could create a perception that there is a free choice about when to reassess the business model.

The Board tentatively decided to confirm that, on initial application of IFRS 4 Phase II, an entity will have to restate comparative information about insurance contracts. The Board agreed with the staff's view that distortion of current and prior period results would be limited, as where entities introduce IFRS 9 before IFRS 4 Phase II, prior period published financial statements will already reflect IFRS 9.

Mirroring approach

The staff proposed not to bring forward into the insurance contracts standard the so-called 'mirroring approach' from the 2013 ED. The mirroring approach aimed to eliminate accounting mismatches for some participating contracts, but would require separation or bifurcation of cash flows: applying different measurement to cash flows varying directly with underlying items, cash flows varying indirectly with underlying items, and all other cash flows. Entities will not be permitted or required to use this approach as, in the light of feedback and concerns raised by constituents on its difficulties, the IASB developed the variable fee approach, under which an insurance contract with direct participation features is viewed as an obligation to pay to policyholders 100% of the fair value of the underlying items less a variable fee for service.

Prior to voting on it, the Board discussed feedback from some constituents that mirroring was necessary for some insurers. The mirroring approach eliminates accounting mismatches between liabilities and underlying items to the extent that an entity expects to settle its liabilities with the underlying items that it holds. Under the proposed insurance contract accounting model (including the approaches that apply to participating contracts) accounting mismatches can arise in the statement of financial position if fulfilment cash flows are based on the fair value of underlying items held but the items themselves are not measured at fair value. The Board noted that the effect of these accounting mismatches may be greater on mutual insurers than proprietary companies. This is because mutual insurers may not have equity, which can cause them to report liabilities that are greater than recognised assets, if those assets are measured at amounts less than fair value. Proprietary companies can normally absorb the effect of accounting mismatches on their reported financial position with equity.

Board members stated that insurance contracts should be treated the same in the standard, regardless of the type of entity, and that the problem of zero equity for a mutual is a wider financial reporting issue and outside the scope of this standard. The staff noted that a variety of entity types may be captured under the term "mutual", with differing liabilities, equity and surplus, and also that some regulators treat unallocated surplus as capital. The staff also noted that IAS 1 *Presentation of Financial Statements* allows reporting entities to present additional line items or to disaggregate line items in the statements of financial position and comprehensive income when relevant to understanding an entity's financial position: mutuals could distinguish liabilities to policyholders in their capacity as policyholders from liabilities to policyholders in their capacity as owners.

The Board agreed unanimously with the staff proposal not to bring forward the mirroring approach.

Presentation and disclosure requirements

The Board voted to confirm the 2013 ED proposals for presentation of line items relating to insurance contracts in the financial statements. The 2013 ED proposed amending IAS 1 for specific items required for insurance contracts.

The Board agreed with the staff recommendation not to require additional line items for contracts under the variable fee approach, since they are still within the scope of the insurance contracts standard, and IAS 1 would not preclude further disaggregation for the presentation of contracts of different nature or function if useful to understanding.

Some Board members favoured further disaggregation or guidance that entities with insurance contracts should take into account the differing nature of cash flows when applying IAS 1, due to the uniqueness of insurance reporting entities. Others thought that this was overstating differences in approach within IFRS 4 Phase II.

The Board unanimously confirmed the disclosure package included in the 2013 ED, subject to tentatively deciding on further disclosure for specific changes made during the redeliberations to date, and in response to comments from users of financial statements and the publication of IFRS 15 *Revenue from Contracts with Customers* (IFRS 15) which are outlined below:

- An entity that measures contracts using the variable fee approach and recognises changes in the value of guarantees embedded in insurance contracts in profit or loss (to minimise accounting mismatches when hedging against economic mismatches) should disclose the amount of that change recognised in the period.
- An entity that chooses to disaggregate interest expense into an amount in profit or loss and an amount in OCI should explain the method used to calculate the cost information in profit or loss.
- Entities with participating contracts that do not apply the current period book yield approach have the option to apply a simplified approach at transition to set the accumulated balance of OCI at zero. Insurers making use of this option should designate financial assets as relating to contracts in the scope of the new standard at the date of transition and disclose, at the date of transition and each subsequent reporting period, a reconciliation from opening to closing balance of the accumulated balance of OCI for those financial assets.
- Disclosure regarding Contractual Service Margin (CSM) for:
    - Changes in fulfilment cash flows that adjust the CSM
    - An explanation of when the entity expects to recognise the remaining CSM in profit or loss either on a quantitative basis using appropriate time bands or by using qualitative information
    - Disclosure of amounts in financial statements determined at transition using simplified approaches, on transition and in subsequent periods
- Disclosure of any practical expedients used in applying the insurance contracts standard, consistent with the disclosure requirements in IFRS 15

The Board also tentatively agreed to remove the following proposed disclosure requirements, in response to concerns of "disclosure overload" from financial statement preparers:

- Reconciliation of revenue recognised in profit or loss in the period to premiums received in the period
- Analysis of the total interest expense between profit or loss and OCI (a tentative decision made in March 2015)

How we see it

The IASB's decision to issue an ED on the deferral and overlay approaches in December with a 60-day comment period demonstrates that it is committed to incorporating these solutions in the existing IFRS 4 expeditiously. Several aspects of the forthcoming ED, such as the predominance test, are expected to elicit comments proposing suggested amendments.

The Board is nearing the end of its redeliberations on its insurance contracts project. However, it has yet to make a final comparison between the general model and the variable fee model. It also remains to be seen how the proposed models will apply to actual portfolios of contracts, and whether other aspects of the standard (e.g., reinsurance accounting) need to be evaluated in the light of recent decisions.

The Board may also decide to have a further debate on the level of aggregation at which the Contractual Service Margin is determined.

What's next?

The Board's next meeting on insurance contracts is expected to be in November. The topics have not yet been announced, but are likely to include further discussion on participating contracts, with a view to concluding on remaining topics this year. The IASB expects to finalise redeliberations within the next few months and issue the new Insurance Contracts standard (IFRS 4 Phase II) in the course of 2016.

The IASB expects to issue the forthcoming ED on amending existing IFRS 4 for IFRS 9 deferral for insurers and the overlay approach in December 2015, with a 60-day comment period, aiming to issue amendments to existing IFRS 4 in the third quarter of 2016.

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