IASB Meeting | Agenda reference **12F**

Staff Paper | Date **21-22 Oct 2009**

Project **Financial Instruments: Replacement of IAS 39**

Topic ***Classification and Measurement* – Transitional insurance issues**

Purpose of this paper

1. **This paper discusses two specific transition issues for insurers:**

   (a) **different effective dates (paragraphs 3-20)**

   (b) **participating contracts (paragraphs 21-28)**

2. This paper does not discuss transition issues that are generic to all entities (see agenda paper 12E)

Different effective dates

3. Insurers may face particular problems if they apply the new IFRS on classification and measurement of financial instruments ('the new IAS 39') before they apply the phase 2 standard on insurance contracts ('the new IFRS 4'):

   (a) They may face two rounds of major change in a short period. (see paragraphs 4-8)

   (b) Reclassification: to minimise accounting mismatches, some insurers may make classification decisions when they adopt the new IAS 39 but wish to make different decisions when they adopt the new IFRS 4. (see paragraphs 9-20)

This paper has been prepared by the technical staff of the IASCF for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

Avoiding two rounds of major changes

4. Most of an insurer's assets are financial assets and most of its liabilities are insurance liabilities or financial liabilities. Thus, if insurers apply the new IAS 39 before they apply the IFRS 4, they may face two rounds of major change in a short time (three rounds for entities switching to IFRSs between now and the date when they first adopt the new IAS 39). This would be disruptive for both users and preparers.

5. The staff recommends in agenda paper 12D that the effective date for the new IAS 39 should be 1 January 2014, with early adoption permitted.

6. The Board has not yet discussed the effective date for the new IFRS 4. The Board plans to publish an exposure draft on insurance contracts in late 2009 or early 2010 and to ballot the resulting IFRS by June 2011. The staff expect to recommend that the Board set an effective date no earlier than 1 January 2014, with early adoption permitted.

7. If the Board accepts those recommendations:

   (a) no insurer would be **compelled** to adopt the new IAS 39 before it adopts the new IFRS on insurance contracts.

   (b) once both IFRSs are published, an insurer could adopt **both** of them early at the same.

8. Thus, no insurer would be **compelled** to adopt the new IAS 39 at one time and the new IFRS 4 at a different time (unless the Board sets a later effective date for the new IFRS 4).

Reclassification

9. If an insurer **chooses** to adopt the new IAS 39 early before it adopts the new IFRS on insurance contracts, this could give rise to two rounds of major changes within a short period. This could disrupt both the continuity of information provided to users and the systems of preparers. We consider below whether the

Board should introduce either of the following measures to minimise such disruption:

(a) Permit insurers to retain the available-for-category until they first apply the new IFRS 4 (paragraph 10).

(b) Permit insurers to elect, when they adopt the new IFRS 4, to reclassify financial assets from amortised cost to fair value through profit or loss (paragraphs 11-20)

Maintain available-for-sale for a temporary period?

10. Some have argued that the Board should permit insurers to adopt the new IAS 39 but maintain the available-for-sale category until they adopt the new IFRS 4. For the following reasons, the staff does not recommend such a deferral:

    (a) If the Board limited such a deferral to assets deemed to be backing insurance contracts, difficult definitional issues would arise.

    (b) If such a deferral were applicable to all financial assets held by an insurer, it would be necessary to define an insurer:

        (i) Our existing definition describes an insurer as the entity that issues an insurance contract. Issuing a single insurance contract ought not to be sufficient to qualify for a deferral for all the entity's financial assets.

        (ii) If we restrict the scope of a possible deferral to entities carrying on a business of insurance, we would need either to create a temporary definition that we would use for no other purpose, or rely on local legal and regulatory definitions.

        (iii) Many groups have both insurance and banking activities. There is no obvious reason to defer application of the new IAS 39 to banking activities.

(c) As noted in paragraph 8, insurers would not be required to adopt the new IAS 39 before the new IFRS 4. If they decide to do so, that would be the result of their own choice.

Reclassification of financial assets on initial adoption of the new IFRS 4

11. The current version of IFRS 4 *Insurance Contracts* permits a wide range of accounting practices to continue. Although some insurers measure insurance liabilities on a current value basis, many other insurers use approaches that are closer to a cost basis. As a result, to avoid accounting mismatches in profit or loss, many insurers classify many of their financial assets as available for sale.

12. If those insurers choose to adopt the new IAS 39 before they adopt the new IFRS 4, they may wish to classify many of their financial assets with basic loan features at amortised cost rather than at fair value through profit or loss. However, the new IFRS on insurer contracts is expected to adopt a current value basis. Thus, when those insurers later adopt the new IFRS 4, they may well wish to reclassify those assets from amortised cost to fair value through profit or loss.

13. For example, suppose that an insurer chooses to adopt the IAS 39 from 1 January 2012 and the new IFRS 4 from 1 January 2014. The insurer may wish to classify its financial assets at amortised cost from 1 January 2012 and reclassify them to fair value through or loss at 1 January 2014. The Board's tentative decisions so far have the following implications:

    (a) The insurer would need to assess at 1 January 2012 whether those financial assets qualify for amortised cost:

        (i) In relation to **business model**, an insurer might demonstrate that it managed the assets on an amortised cost basis up to 31 December 2013 and on a fair value basis from 1 January 2014. Would that fact be sufficient reason to argue that its business model changed on 1 January 2014, thus requiring a reclassification at that date?

(ii) In relation to **basic loan features**, suppose that at 1 January 2012 the instrument contains some features that are not basic loan features but those features have all expired by 1 January 2014. Thus at 1 January 2012, the insurer must classify the assets at fair value through profit or loss. In line with the Board's tentative decisions on 15 October, the insurer could not reclassify the instrument to amortised cost on 1 January 2014.

(b) The insurer would need to assess at 1 January 2012 whether it wishes to use the fair value option for any of the financial assets that would otherwise qualify for amortised cost. The insurer could not subsequently reclassify assets from amortised cost to fair value through profit and loss or vice versa.

14. The Board faced a similar issue when it issued IFRS 4. Paragraph 45 of IFRS 4 permits, but does not require, an insurer to reclassify some or all financial assets as 'at fair value through profit or loss' when the insurer first adopts IFRS 4. Paragraph D4 of IFRS 1 *First-time Adoption of International Financial Reporting Standards* (as revised in 2008) provides the same option for first-time adopters.

15. The purpose of this option was to permit an insurer to avoid artificial mismatches on adopting IFRS 4.[1] Some believe that reasoning will be equally applicable for insurers adopting the new IFRS 4. Thus, they believe the Board should provide a similar exemption for entities adopting the new IFRS 4 for the first time (including first-time adopters).

16. However, if the Board does make such an exception, it will need to resolve several issues:

[1] IFRS 4.BC145

(a) The existing option in IFRS 4 does **not** restrict reclassification to assets backing the insurance contracts for which the accounting policies were changed. Would the Board wish to create such a restriction (or any other restriction)? If so, how would the Board define the assets within the scope of the option?

(b) The Board decided tentatively on 15 October that when an entity reclassifies an instrument into the fair value category, it should remeasure the instrument to fair value at the date of reclassification and recognise the effect of the remeasurement on a separate line item in profit or loss, with additional disclosure. In contrast, the existing option in IFRSs requires the insurer to treat the reclassification as a change in accounting policy, so the effect of the remeasurement would be recognised by adjusting retaining earnings at the beginning of the earliest period presented. Which of these treatments would the Board adopt?

(c) Would the Board **permit** reclassification or **require** it?

(d) Would the reclassification be prospective or retrospective?

(e) Would reclassification be limited to financial assets, or could insurers also apply it to financial liabilities, such as the long-term savings contracts and other investment contracts that many insurers issue? Some insurers may wish to continue using amortised cost (if eligible) for such contracts until they adopt the new IFRS 4, and then switch to fair value at that date.

(f) The Board has tentatively decided to require disclosures about assets reclassified on initial application of the new IAS 39. Should similar disclosure requirements apply to reclassifications made on initial adoption of the new IFRS 4?

17. Because IFRS 4 permits a wide range of existing accounting treatments to continue, IFRS 4 permits an insurer to change its accounting policies for insurance contracts, subject to constraints specified in paragraph 21-30 of

IFRS 4. To avoid creating "unnecessary barriers for those insurers that wish to move to a more consistent measurement basis that reflects fair values",[2] when an insurer changes its accounting policies after initial adoption of IFRS, paragraph 45 of IFRS 4 permits the insurer to reclassify some or all of their financial assets as at fair value through profit or loss. However, presumably, there will no longer be a need to provide that reclassification option once an insurer has already adopted the new IFRS 4.

Staff comments on reclassification

18. If the new IFRSs on classification and measurement of financial instruments (the new IAS 39) and on insurance contracts (the new IFRS 4) are both mandatory from the same date, and both permit early adoption, no insurer would be **compelled** to adopt the new IAS 39 before it adopts the new IFRS 4.

19. Some insurers may **choose** to adopt the new IAS 39 before they adopt they new IFRS 4. That could lead to new, temporary accounting mismatches. Although an option similar to that in paragraph 45 of IFRS 4 might reduce some of those accounting mismatches, the Board would need to answer many difficult questions if it wished to create such an option (see paragraph 16). The staff believes that answering those questions would be time consuming and lead to transitional provisions of excessive complexity.

20. If the Board does create an option or requirement for an insurer to reclassify financial instruments when the insurer adopts the new IFRS 4, the Board could not insert that option or requirement immediately in the new IAS 39 because the new IFRS 4 would not yet exist. However, the Board could confirm in the Basis for Conclusions on the new IAS 39 whether it intends to create such an option or requirement.

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[2] IFRS 4.BC145(a)

Question 1 to the Board
The staff recommends that the Board: (a) should not create a temporary exemption that permits insurers adopting the new IAS 39 to maintain the available-for-sale category until they adopt the standard being developed in the Board's project on insurance contracts (the new IFRS 4). (b) should not create a transitional option for insurers to reclassify financial assets when they first adopt the new IFRS 4. The Board should confirm in the Basis for Conclusions on the new IAS 39 that it sees no need for such a transitional option, because it expects that no insurer would be compelled to adopt the new IAS 39 before it adopts the new IFRS on insurance contracts. (If the Board decides subsequently to set a later effective date for IFRS 4 than for the new IAS 39, the staff will revisit this issue.) Does the Board agree?

Participating contracts

21. Some insurance contracts contain a discretionary participation feature (DPF) as well as a guaranteed element. IFRS 4 defines a DPF as "A contractual right to receive, as a supplement to guaranteed benefits,[3] additional benefits:

    (a) that are likely to be a significant portion of the total contractual benefits;

    (b) whose amount or timing is contractually at the discretion of the issuer; and

    (c) that are contractually based on:

        (i) the performance of a specified pool of contracts or a specified type of contract;

[3] IFRS 4 defines guaranteed benefits as "payments or other benefits to which a particular policyholder or investor has an unconditional right that is not subject to the contractual discretion of the issuer".

(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or

(iii) the profit or loss of the company, fund or other entity that issues the contract.

22. Features of this kind are found not only in insurance contracts but also in some other financial instruments (often known informally as investment contracts with a DPF). Financial instruments with a DPF are scoped out of IAS 39 and within the scope of IFRS 4.

23. At present, issuers of (insurance or investment) contracts with a DPF often use the available-for-sale category for some or all of the assets whose performance drives the payouts to holders of those contracts. To avoid an accounting mismatch, they often use other comprehensive income (OCI) to report those changes in the measurement of the liability that are driven by asset gains and losses recognised in OCI. This is one example of a group of practices sometimes known as "shadow accounting".[4]

24. When the new IAS 39 is in place, if insurers continue using OCI for gains and losses on equity investments and those gains and losses affect the benefits for holders of contracts with a DPF, insurers may want to continue using shadow accounting for those gains and losses. However, IFRS 4 currently deals only with cases where some or all gains or losses on the assets backing insurance liabilities are recognised in OCI (and in the context of a model in which the measurement of those liabilities depends partly on the measurement of the assets backing them). It does not deal with cases where (in the context of such a model), gains and losses on the assets are recognised in OCI and never recycled to profit or loss.

25. As a result, some insurers have expressed concerns that an accounting mismatch will arise if the assets backing insurance liabilities include equity investments and the insurer elects to present gains and losses on those investments in OCI.

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[4] IFRS 4.30

The accounting mismatch would arise because paragraph 30 of IFRS 4 does not give explicit authority to apply shadow accounting in such cases.

Staff comments on shadow accounting

26. Because IFRS 4 deals with shadow accounting, the staff believes that no transitional provisions are needed to permit its use to continue.

27. The appendix to this paper includes draft wording that the Board could use if it wanted to extend the description of shadow accounting to cover cases when OCI is used for realised gains and losses on assets backing insurance contracts.

28. However, the staff does not recommend extending the description of shadow accounting in that way. Insurers would face an accounting mismatch in such cases only if they elected to use the OCI presentation alternative for equity investments backing such insurance contracts. The Board created the OCI presentation alternative for strategic investments. Although we have been unable to define strategic investments, the staff does not regard assets backing insurance contracts as strategic investments. Accordingly, changing IFRS 4 to encourage insurers to use the OCI presentation alternative for assets backing insurance contracts would not be consistent with the Board's objectives in creating that presentation alternative.

Question 2 to the Board
The staff believes that the Board should not make any changes to IFRS 4 relating to shadow accounting for (a) insurance contracts or (b) financial instruments containing a discretionary participation feature. Does the Board agree?

Appendix

Shadow accounting

Possible wording for a consequential amendment to IFRS 4

Shadow accounting

30 In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of (a) its insurance liabilities, (b) related deferred acquisition costs and (c) related intangible assets, such as those described in paragraphs 31 and 32. An insurer using such a model is permitted, but not required, to change its accounting policies so that:

(a) a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in other comprehensive income if, and only if, the unrealised gains or losses are recognised in other comprehensive income.

(b) if a realised gain or loss on an asset is recognised in other comprehensive income, the related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) is also recognised in other comprehensive income.

This practice is sometimes described as 'shadow accounting'.

Comments:

1. Amendment to the second sentence to clarify that shadow accounting is applicable only when an entity applies an accounting model in which realised gains or losses on assets affect the measurement of liabilities. As noted in IFRS 4.BC184, the Board does not expect such models to survive into phase 2.
2. As noted in IFRS 4 BC.183-184, the Board decided to permit, but not require shadow accounting because the Board did not expect the model underlying shadow accounting to survive into phase 2. The above amendments retain that approach.