

STAFF PAPER

22 – 24 January 2014

IASB Meeting

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| Project | Financial Instruments: Classification and Measurement | | |
| Paper topic | Interaction between the classification and measurement of financial assets and the accounting for insurance contracts liabilities | | |
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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Purpose and structure of the paper

1. This paper discusses the interaction between the classification and measurement of financial assets under IFRS 9 *Financial Instruments* (including the tentative decisions made by the IASB in re-deliberating the exposure draft ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (Proposed amendments to IFRS 9 (2010)) ('the Limited Amendments ED')) and the accounting for insurance contracts liabilities under the exposure draft ED/2013/7 *Insurance Contracts* ('the 2013 Insurance Contracts ED').
2. Specifically, this paper:
 - (a) Provides a summary of the relevant background information (paragraphs 5-11);
 - (b) Discusses the feedback received on the Limited Amendments ED related to the interaction between the classification and measurement of financial assets and the accounting for insurance contracts liabilities (paragraphs 12-15);
 - (c) Provides staff discussion and analysis of that interaction and the interaction between these projects (paragraphs 16-24).
3. This paper discusses the interaction between the *accounting models* for financial assets and insurance contracts liabilities and the interaction between the respective

IASB's projects. It does not discuss the respective transition provisions for IFRS 9 and the new insurance contracts standard or their respective effective dates. Transition to IFRS 9 will be discussed in IASB Agenda Papers 6C-6D for this month's meeting. The staff plan to bring a paper on the mandatory effective date of IFRS 9 in February 2014. Transition to and the effective date of the new insurance contracts standard will be discussed during the IASB's re-deliberations of its insurance contracts proposals.

4. This paper is for informational purposes only.

Background

5. In November 2009, the IASB issued IFRS 9 that set out new requirements for the classification and measurement for financial assets and established two measurement categories for financial assets: amortised cost and fair value through profit or loss (FVPL). The IASB acknowledged the difficulties that might be created by differences in timing between that project and others, in particular the Insurance Contracts project. Thus the IASB stated that it will consider the interaction between the classification and measurement of financial assets and the accounting for insurance contracts liabilities when the insurance contracts model has been sufficiently developed.
6. In July 2010, the IASB published the exposure draft ED/2010/08 *Insurance Contracts* ('the 2010 Insurance Contracts ED'). The 2010 Insurance Contracts ED proposed that insurance contracts liabilities would be measured on the statement of financial position using a current value approach. Under these proposals, the effects of re-measuring insurance contracts liabilities would be presented in profit or loss.
7. In the re-deliberations of the 2010 Insurance Contracts ED, the IASB tentatively re-affirmed the current value approach for measuring insurance contracts liabilities. However, the IASB decided to propose that the effects of changes in the discount rates used to measure the current value of insurance contracts liabilities should be disaggregated and presented in other comprehensive income

(OCI) rather than profit or loss. Those tentative decisions were reflected in the 2013 Insurance Contracts ED.

8. In November 2011, the IASB decided to consider making limited amendments to IFRS 9. In making that decision, the IASB sought to achieve the following three objectives:
 - (a) address specific application questions raised by interested parties;
 - (b) take into account the interaction of the classification and measurement model for financial assets with the IASB's Insurance Contracts project; and
 - (c) reduce key differences with the US Financial Accounting Standards Board's (FASB) tentative classification and measurement model for financial instruments.
9. In view of the above, the Limited Amendments ED proposed the introduction of a third mandatory measurement category—fair value through other comprehensive income (FVOCI). Under the proposals, debt instruments would be measured at FVOCI if they:
 - (a) are held within a business model in which financial assets are managed both in order to collect contractual cash flows and for sale ('the hold and sell business model'); *and*
 - (b) have contractual cash flows that are solely payments of principal and interest ('solely P&I').
10. Mechanically, the proposed FVOCI category would present amortised cost information in profit or loss and fair value information on the statement of financial position. The Limited Amendments ED also proposed that the Fair Value Option (FVO) for accounting mismatches that is currently available for financial assets that qualify for amortised cost be extended to financial assets that qualify for FVOCI.
11. The majority of respondents to the Limited Amendments ED, including users of financial statements, supported measuring some financial assets at FVOCI. Detailed discussion of the relevant feedback is provided in IASB Agenda Paper 6A for the May 2013 meeting, IASB Agenda Paper 6A for the June 2013 meeting

and IASB Agenda Paper 6C for the November 2013 meeting. Accordingly, in November 2013, the IASB tentatively decided to re-affirm the introduction of the FVOCI mandatory measurement category into IFRS 9 as proposed by the Limited Amendments ED.

Feedback on the interaction between the classification and measurement of financial assets and the accounting for insurance contracts liabilities

12. Many respondents to the Limited Amendments ED—representing a variety of jurisdictions and including insurers, users of financial statements, standard setters, insurance and securities regulators and auditors—specifically commented on the interaction between the classification and measurement of financial assets and the accounting for insurance contracts liabilities. In addition, that interaction was discussed in the outreach activities.
13. Most respondents who provided feedback in this area supported the IASB’s efforts to consider that interaction. However, a few said that in addressing that interaction the IASB should not increase the overall complexity of IFRS 9 for *all* entities. A few noted also that the interaction should be considered further when the Insurance Contracts project is closer to finalisation and / or indicated that they are not able to finalise their views on the proposals in the Limited Amendments ED until they are able to fully assess the combined effect of the accounting models for financial assets and insurance contracts liabilities.
14. Most respondents who provided feedback in the area, including insurers and users of financial statements, **welcomed the proposed FVOCI measurement category for financial assets**. Those respondents believed that the FVOCI measurement category for financial assets—in combination with the use of OCI in the IASB’s tentative accounting model for insurance contracts liabilities—goes a long way to reduce the accounting mismatches that would otherwise arise as a result of measuring financial assets at amortised cost or FVPL and measuring insurance contracts liabilities at a current value with the effects of changes in the discount rates presented in OCI. They stated that the introduction of the FVOCI measurement category for financial assets represents a significant improvement compared to existing IFRS 9 and stated that the FVOCI measurement category is

a critical element of accounting for financial assets for insurers and will result in more relevant and useful information about insurers' performance. They noted that the hold or sell business model is one that is relevant for many entities who write insurance contracts.

15. At the same time, many respondents, notably preparers who issue insurance contracts, requested that the IASB further consider the interaction between the classification and measurement of financial assets and the accounting for insurance contracts liabilities. They requested that the IASB further reduce accounting mismatches and / or provide greater flexibility to insurers in accounting for their insurance liabilities and financial assets. Specifically, respondents made the following comments and suggestions—many of which are interrelated:

- (a) **Ultimately the accounting for financial assets and insurance contracts liabilities should better reflect the asset-liability management (ALM) that is central to the insurance business.**
- (b) **The FVOCI measurement category should not be limited to financial assets with solely P&I cash flows.** For example, some said that it should also be available to other types of financial assets, such as equity investments, derivatives, hybrid financial assets or even particular non-financial assets such as real estate.
- (c) **The FVOCI measurement category for financial assets should be an option,** either in addition to or instead of the mandatory FVOCI measurement category. Several variations—or combinations thereof—were suggested:
 - (i) FVOCI option for financial assets that back insurance contracts liabilities and that would otherwise be classified at FVPL under IFRS 9;
 - (ii) FVOCI option for financial assets that back insurance contracts liabilities and that would otherwise be classified at amortised cost under IFRS 9;
 - (iii) Unrestricted FVOCI option for financial assets that would otherwise be measured at amortised cost;

- (iv) Unrestricted FVPL option for financial assets that would otherwise be measured at FVOCI.
- (d) **Insurers should be able to measure more items at FVPL.**
- Suggestions in this area included an unrestricted fair value option (FVO) for financial assets as well as FVPL accounting for insurance contracts liabilities. With regards to the latter, respondents made various suggestions, including:
- (i) Permitting rather than requiring entities to present the effects of changes in the discount rates in OCI; ie making the OCI presentation for insurance contracts liabilities optional rather than mandatory;
 - (ii) Permitting entities to measure insurance contracts liabilities at FVPL; ie providing a FVO for insurance contracts liabilities.

Staff discussion and analysis

Classification and measurement of financial assets

16. The staff note that the feedback received about the interaction between the classification and measurement of financial assets and the accounting for insurance contracts liabilities is consistent with the other feedback received on the Limited Amendments ED. That is, most respondents support the proposed introduction of the FVOCI mandatory measurement category for financial assets and agree that it contributes to achieving the objectives that the IASB set out for its Limited Amendments ED as described in paragraph 8. However, as noted above, many of those commenting on the interaction wanted additional changes to address accounting mismatches for entities that have insurance contracts liabilities.
17. However, the staff note that the IASB's objective was to *improve* the interaction between the classification and measurement of financial assets and the accounting for insurance contracts liabilities—rather than to fully align the two accounting models. The feedback received indicates that such an improvement has been

achieved by the proposals in the Limited Amendments ED, which have been re-affirmed in the IASB's de-deliberations to date.

18. In addition, the staff note that the Limited Amendments ED proposed important changes relevant to many entities that have insurance contracts liabilities—namely the introduction of the FVOCI mandatory measurement category that reflects a hold to collect or sell business model and a FVO that applies to financial assets that would otherwise be measured at FVOCI. These proposals (with some clarifications) have been confirmed in redeliberations. By describing a business model relevant to many entities that hold insurance contracts, introducing a new measurement category (FVOCI) and extending the FVO for accounting mismatches that is currently available for financial assets that would otherwise be measured at amortised cost to financial assets that would otherwise be measured at FVOCI, in a sense a number of ‘tools’ have been made available that the IASB can consider when finalising the accounting for insurance contract liabilities. That may assist in enabling entities that hold insurance contracts to faithfully represent their performance.
19. However, the staff note that some of the specific requests and suggestions made by respondents on further aligning the classification and measurement of financial assets and the accounting for insurance contracts liabilities (discussed in paragraph 15) would entail a *fundamental reconsideration* of the classification and measurement principles for financial assets in IFRS 9.
20. For example, **broadening the FVOCI measurement category**—or providing an **option** to measure assets at FVOCI. This would contradict:
- (a) the contractual cash flow characteristics assessment in IFRS 9 if financial assets with non-solely P&I cash flows (such as derivatives or hybrid financial assets) could be measured at other than FVPL;
and / or
 - (b) the business model assessment in IFRS 9 if financial assets that are held for the collection of contractual cash flows (eg ‘simple’ illiquid loans and mortgages) were required—or permitted—to be measured at FVOCI.

In the staff's view this would significantly undermine one of the primary benefits of IFRS 9—that the classification of financial assets is based on clear criteria that enhance understanding for users of the financial statements.

21. Similarly, that staff do not believe that **broadening the use of FVO** for financial assets would be appropriate or desirable. As the IASB noted in the discussion of the FVO at its December 2013 meeting, broadening the FVO would have the effect of significantly undermining the business model assessment as a basis for measurement in IFRS 9. Also, historically the FVO for financial instruments under IFRS has been restricted to address particular circumstances—such as eliminating or significantly reducing accounting mismatches—because many interested parties (notably supervisors of banks) have expressed long-standing concerns about permitting an unrestricted FVO. In addition, the staff note that users of financial statements have consistently opposed permitting too much optionality in accounting requirements and advocated requirements that provide consistency and comparability.
22. To conclude, the feedback on the Limited Amendments ED indicates that the introduction of the FVOCI measurement category for financial assets describes a business model relevant to many entities that hold insurance contracts and results in an improved interaction between that model and the IASB's tentative model for insurance contracts liabilities. The FVO for financial assets that would otherwise be measured at either amortised cost or FVOCI also assists in this interaction.
23. The staff are thus of the view that the IASB achieved the objectives of the Limited Amendments to IFRS 9 regarding improving the interaction between classification and measurement of financial assets and the accounting for insurance contracts liabilities.

Accounting for insurance contracts liabilities

24. The staff note that some of the feedback received on the Limited Amendments ED relates to accounting for insurance contracts liabilities and the assets that specifically back those contracts rather than the accounting for financial assets more generally (refer to paragraph 15). One of the targeted areas of the 2013 Insurance Contracts ED is the proposal to present the effects of changes in

discount rates in OCI rather than in profit or loss. In redeliberating the feedback received on the 2013 Insurance Contracts ED, consideration will be given to whether the IASB should proceed with that proposal. That will include consideration of whether the accounting for insurance contracts should be modified to reflect the interaction with the accounting requirements for assets, including financial assets accounted for under IFRS 9 as amended by the Limited Amendments project.

Question for the IASB

Does the IASB have any comments or questions on the discussion in this paper?