STAFF PAPER

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Project	**Insurance contracts**		
Paper topic	Initial application of the new insurance contracts Standard after implementation of IFRS 9 *Financial Instruments*		
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Purpose of this paper

1. This paper considers transition reliefs for the initial application of the new insurance contracts Standard. The reason for this paper is that the IASB's previously stated intention to allow a period of approximately three years between publishing a final Standard on insurance contracts and when that Standard comes into effect means that the earliest possible mandatory effective date of the new insurance contracts Standard will now be after 1 January 2018, the mandatory effective date of IFRS 9 *Financial Instruments* (IFRS 9).

2. In this paper the staff recognise that many preparers are concerned that they will be required to apply the classification and measurement requirements of IFRS 9 without the opportunity to fully evaluate the implications of the new insurance contracts Standard. Consequently, this paper asks whether the IASB wishes the staff to consider further transition reliefs in addition to those proposed in the 2013 Exposure Draft *Insurance Contracts* (2013 ED), in order to reduce the uncertainty that might arise when entities apply IFRS 9 before the initial application of the new insurance contracts Standard.

3. This paper does not address the mandatory effective date of the new insurance contracts Standard. This will be discussed after the deliberations on the model for contracts with participation features have been completed.

4. The Appendices to this paper are as follows:

   (a) Appendix A illustrates possible accounting mismatches between financial assets and insurance liabilities.

   (b) Appendix B and C includes relevant extracts from the 2013 ED and IFRS 9.

Recommendation

5. The staff recommend that the IASB confirms the proposals in the 2013 ED that, on the initial application of the new insurance contracts Standard:

   (a) an entity is permitted to newly designate financial assets under the fair value option as measured at fair value through profit or loss to eliminate (or significantly reduce) an accounting mismatch according to paragraph 4.1.5 of IFRS 9;

   (b) an entity is required to revoke previous fair value option designations for financial assets if the accounting mismatch that led to the previous designation according to paragraph 4.1.5 of IFRS 9 no longer exists; and

   (c) an entity is permitted to newly designate an investment in an equity instrument as measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 and is permitted to revoke previous designations.

6. In addition, staff are asking if the IASB wishes to consider providing further transition relief to permit or require an entity to reassess the business model for financial assets at the date of initial application of the new insurance contracts Standard. This reassessment would be based on the conditions for assessing the business model in paragraphs 4.1.2(a) or 4.1.2A(a) of IFRS 9 and the facts and circumstances that exist at the date of the first application of the new insurance contracts Standard.

7. If the IASB wishes to provide such further transition relief, the staff will consider consequential issues arising, as described in paragraph 31.

Background

Requirements for financial assets and insurance liabilities

Financial assets

8. IFRS 9, which was published in July 2014 and has a mandatory effective date of 1 January 2018, brings together all the phases of the IASB's project to replace IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 includes, amongst other improvements, a single classification and measurement approach for financial assets that reflects the business model and cash flows characteristics. It measures assets at fair value through profit or loss (FVPL), fair value through other comprehensive income (FVOCI) and amortised cost[1].

Insurance contract liabilities

9. The existing IFRS 4 is an interim Standard that allows insurers to continue to use various accounting practices that had developed over the years, pending the completion of a comprehensive Standard for insurance contracts. The new insurance contracts Standard will replace existing IFRS 4, and is intended to eliminate inconsistencies and weaknesses in those various existing practices by providing a single principle-based framework to account for all types of insurance contracts. The proposed measure of insurance contracts will be based on the current estimate of the uncertain future obligation, with changes in that current estimate reported in different line items depending on the nature of the change.

2013 ED transition proposals

10. Entities that issue insurance contracts thus expect changes to the accounting for both the insurance contracts and the financial assets. In the deliberations leading to the 2013 ED, the IASB noted that if the effective dates of the new insurance contracts Standard and IFRS 9 were the same, an entity could evaluate the changes of the accounting for insurance contracts and related financial assets at the same time. However, the IASB acknowledged that it would need to consider the consequences of any difference in timing between the initial application of

[1] Please refer to section 4.1 of IFRS 9 – relevant extracts are included in Appendix C.

IFRS 9 and the initial application of the new insurance contracts Standard. In particular, the IASB has sought to ensure that any such timing difference would not disadvantage entities that apply the new insurance contracts Standard.

11. As a result, the 2013 ED proposed transition relief that would apply when an entity initially applies the new insurance contracts Standard after having first applied IFRS 9[2], as follows:

(a) an entity would be permitted to designate financial assets using options/elections available in IFRS 9 that are normally only applicable on the initial recognition of financial assets (or at the date of initial application of IFRS 9), as follows:

(i) an entity is permitted to newly designate financial assets under the fair value option as measured at FVPL to eliminate (or significantly reduce) an accounting mismatches according to paragraph 4.1.5 of IFRS 9; and

(ii) an entity is permitted to newly designate an investment in an equity instrument as measured at FVOCI in accordance with paragraph 5.7.5 of IFRS 9 and is permitted to revoke previous designations,

(b) an entity is required to revoke previous fair value option designations for financial assets if the accounting mismatch that led to the previous designation according to paragraph 4.1.5 of IFRS 9 no longer exists.

12. For all other circumstances not specified in paragraph 10, an entity would reclassify financial assets only when required by IFRS 9. In particular, paragraph 4.4.1 of IFRS 9 requires an entity to reclassify all affected financial assets when (and only when) it changes its business model for managing financial assets. Such a change is determined by the entity’s senior management as a result of external or internal changes and must be significant to the entity’s operations and demonstrable to external parties[3].

[2] Please refer to Appendices B and C for the relevant extracts from the 2013 ED and IFRS 9.

[3] Please refer to Appendix C for the relevant extracts from the IFRS 9.

13. When the transition proposals in the 2013 ED were developed, there was a possibility that the entity may be able to apply both IFRS 9 and the new insurance contracts Standard for the first time together. That is no longer the case.

Feedback received on the 2013 ED

14. The staff note that this feedback was received before the IASB finalised the mandatory effective date of IFRS 9.

15. Most constituents believe that it would be ideal if the effective dates of the new insurance contracts Standard and IFRS 9 were aligned. This is because:

    (a) it would avoid imposing two rounds of substantial accounting changes on entities that issue insurance contracts and on users of financial statements. Preparers are concerned about the practical issues related to implementing those changes and accounting mismatches it could create, and both preparers and users are concerned that it could impair understandability of financial statements. The issue of two rounds of substantial accounting changes is discussed in paragraphs 17-21.

    (b) they are concerned that the designations and assessments made on initial application of IFRS 9 might not be those that would have been made if the new insurance contracts Standard had already been effective. This is discussed further in paragraphs 22-25.

16. Nonetheless, while many constituents would prefer alignment of effective dates, most constituents recognise that IFRS 9 should not be delayed only because of the new insurance contracts Standard. (The IASB agreed with that conclusion when it set the mandatory effective date for IFRS 9.) Thus, if the dates cannot be aligned, they suggest:

    (a) entities that apply the new insurance contracts Standard should be given an option to defer application of IFRS 9;

    (b) entities that apply IFRS 9 before applying the new insurance contracts Standard should be permitted a more wholesale opportunity to redesignate accounting treatments for financial assets and to reassess the business model in which the entity holds financial assets; and/or

(c) if the IASB decides to finalise IFRS 9 before finalising the new insurance contracts Standard, that it should delay the mandatory effective date of the insurance contracts Standard so that it is at least three years after the mandatory effective date of IFRS 9, to avoid entities having to make two fundamental changes in a short period.

Staff analysis

Two significant system changes in a short period

17. As noted in paragraph 15(a), the finalisation of the new insurance contracts Standard could require entities to make two significant changes to their accounting within a short period. This results in the following challenges:

(a) practical application of two big changes on the systems and the impact on other resources;

(b) the need for preparers to educate users of financial statements about the reasons for the two significant changes, and to explain their effects on financial statements within a short time period; and

(c) the need to make judgements on how best to classify financial assets on the initial application of IFRS 9 in a way that minimises accounting mismatches both before and after the new insurance contract Standard is applied.

Deferring the mandatory effective date of IFRS 9

18. As noted in paragraph 16(a), some constituents believe that the IASB should allow entities that issue insurance contracts to defer the mandatory effective date of IFRS 9 to resolve the issues discussed in paragraph 17. However, in February 2014, the IASB considered the interaction between the respective mandatory effective dates of IFRS 9 and the forthcoming new insurance contracts Standard, including the possibility of deferring the mandatory effective date of IFRS 9. At that meeting, the IASB decided that the mandatory effective date of IFRS 9 should not depend on the timing of the new insurance contracts Standard. The IASB noted that if the mandatory effective date of IFRS 9 for entities that issue

insurance contracts was dependent on the timing of the new insurance contracts Standard, it could create confusion in the financial market because:

(a) It would impair comparability of the financial statements of entities that issue insurance contracts with entities that do not; and

(b) It would create an arbitrary line for entities that have both insurance and other types of business because the IASB would need to develop criteria to decide which of these entities could defer the mandatory effective date of IFRS 9.

19. In addition, during that discussion Board Members noted that:

(a) IFRS 9 is a significant improvement from the current requirements for financial instruments and therefore, all entities should be required to apply those new requirements at the same time; and

(b) it might not be feasible to defer the application of IFRS 9 only for entities that are significantly affected by the new insurance contracts Standard. IFRS 4 applies to insurance *contracts*, not insurance *entities*, and IASB Members thought it would be difficult to define an insurance entity in a robust way that could be applied consistently from country to country. In addition, the IASB does not issue industry-specific Standards.

20. At that meeting, the IASB set the effective date of IFRS 9 (ie 1 January 2018), which is included in the completed version of IFRS 9 that was issued in July 2014.

21. Some constituents suggested that practical and communication difficulties discussed in paragraph 18 could be addressed by allowing a longer period after IFRS 9 is mandatorily effective before the new insurance contracts Standard must be applied. The staff will assess this proposal when it considers the mandatory effective date of the new insurance contracts Standard.

Potential accounting mismatches

22. As noted in paragraph 15(b), a further issue is in judging how best to classify financial assets on initial application of IFRS 9. The staff assume that entities would seek to minimise accounting mismatches between financial assets that an

entity holds and insurance contracts liabilities both before and after the new insurance contract Standard is applied. Such mismatches could occur as follows:

(a) The initial application of IFRS 9 (with the existing IFRS 4) might cause an entity to change the classification and measurement of financial assets without changing the accounting for insurance contracts. This is considered in paragraphs 23-25.

(b) The initial application of the new insurance contracts Standard after IFRS 9 has been applied might cause accounting mismatches if an entity is not able to reconsider the classification of its financial assets. This is discussed in paragraphs 26-31.

Applying IFRS 9 for the first time with the existing IFRS 4

23. The change in accounting for financial assets as a result of applying IFRS 9 will depend on each entity's individual circumstances. In particular, the overall change will depend on the choices/designations previously made by preparers in applying IAS 39, their business models for managing the financial assets and the contractual cash flow characteristics of their financial assets. In some cases the measurement of financial assets will not be changed by the application of IFRS 9 and thus no specific issues would arise simply due to its application. However, in other cases the measurement of financial assets will be changed by the application of IFRS 9. Appendix A provides a summary of the possible accounting mismatches between financial assets and insurance liabilities under the current requirements and changes of those mismatches under the initial application of the new requirements of IFRS 9 and the proposed requirements of the new insurance contracts Standard.

24. In many cases, the staff expect that an entity may choose to minimise accounting mismatches between financial assets and insurance contract liabilities at initial application of IFRS 9 by:

(a) Using options available in IFRS 9[4] according to which an entity may designate:

[4] Please refer to Appendix C for the relevant extracts from IFRS 9.

(i) a financial asset as measured at fair value through profit or loss under the fair value option according to paragraph 4.1.5; and

(ii) an investment in an equity instrument at fair value through OCI in accordance with paragraph 5.7.5.

(b) Changing its accounting policy for insurance contracts in accordance with existing IFRS 4 if that change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs. (However, as the IASB is in the final stages of the project on the accounting for insurance contracts, entities are unlikely to change their accounting policy for insurance contracts because it would be costly to have two significant changes for the accounting of insurance contracts in a short period.)

(c) Applying the new insurance contracts Standard before its mandatory effective date. The staff expect that the IASB will finalise the new insurance contracts Standard before the mandatory effective date of IFRS 9 and to confirm the proposal in the 2013 ED that early application of the new insurance contracts Standard will be permitted. Nonetheless, early application of the new insurance contracts Standard may not be possible at the same time as the initial application of IFRS 9 because of the significant system changes that many entities will need to make to apply the new insurance contracts Standard.

25. Nonetheless, some preparers are concerned that:

(a) The judgments needed to apply the classification and measurement of financial assets when insurance contracts are measured using existing IFRS 4 might differ from those when insurance contracts are measured using the new insurance contracts Standard.

(b) Although they would be able to assess the most appropriate classification and measurement of financial assets in the context of existing IFRS 4, there remains some uncertainty about how changes in the current fulfilment value of the insurance contract will be recognised under the new insurance contracts Standard. Therefore, they think it is not possible for them to assess the most appropriate classification and measurement of financial assets in the context of the new insurance contracts Standard at this time.

Transition relief when applying new insurance contracts Standard for the first time

26. As noted in paragraph 10, the 2013 ED proposed that on initial application of the new insurance contracts Standard an entity may be able to address accounting mismatches by revisiting the options determined at the initial recognition of the financial assets such as the fair value option and the fair value through OCI election for some equity investments. Many constituents welcomed those proposals in the 2013 ED because they address some accounting mismatches. Consequently, the staff recommend that the IASB confirm those proposals.

27. However, the feedback indicated that the transition relief proposed in the 2013 ED may not go far enough because it would not allow an entity that issues insurance contracts to reassess the business model for all financial assets. As a result, unless the threshold for reclassification in IFRS 9 is met, which is expected to be very infrequent, an entity would be unable to change the classification of financial assets when it first applies the new insurance contracts Standard[5].

28. The staff note that a change in accounting policy caused by the application of the new insurance contracts Standard would not, by itself, result in a change in the entity's business model for managing financial assets. In some cases, application of the new insurance contracts Standard might be one factor that causes an insurer to modify the objective of its business model. Such modifications are unlikely to meet the threshold for reclassifying financial assets in accordance with IFRS 9. However, if the entity had initially applied IFRS 9 after the modified (ie new) objective was in place, the entity might have come to a different conclusion about the objective of the business model for the financial assets, and hence might have classified them differently.

[5] See section 4.4 and paragraph B4.4.1 of IFRS 9. Appendix C sets out the relevant extracts from IFRS 9.

29. As a result, the staff believe that the relative timing of IFRS 9 and the new insurance contracts Standard places entities issuing insurance contracts, in effect, in an extended transition period until the effective date of the new insurance contracts Standard. To mitigate the uncertainty during that extended transition period, the IASB could consider additional transition reliefs to those proposed in the 2013 ED (set out in paragraph 10) by permitting entities that issue insurance contracts to reassess the business model for financial assets based on the facts and circumstances that exist at the date of transition to the new insurance contracts Standard. That assessment would be done in the same manner as the assessment of the business model the entity would perform on the initial application of IFRS 9.

30. The staff believe that this approach could allow an entity to provide better information in the financial statements about the combined effect of the insurance contracts the entity issues and the related financial assets, in particular by minimising accounting mismatches when IFRS 9 is first applied, both before *and* after the new insurance contracts Standard is first applied. This is because:

    (a) In the first period when IFRS 9 is applied, and the existing IFRS 4 remains in place, entities will be able to minimise accounting mismatches under the existing requirements without second-guessing the outcome of the IASB's project on insurance contracts.

    (b) On initial application of the new insurance contracts Standard, entities will be able to determine the appropriate accounting based on facts and circumstances that exist at that date. This may have changed from when IFRS 9 was first applied.

31. The staff note that if the IASB were to agree to consider providing such additional transition relief, the staff will consider at a future meeting the following:

    (a) the financial assets for which the transition relief would apply;

    (b) when there is a change in assets' classification at the date of applying the transition relief in the new insurance contracts Standard,

        (i) whether such a change should be applied prospectively or retrospectively; and

(ii) how any resulting gains or losses should be treated; and

(c) disclosures if the business model for financial assets is changed on the first application of the new insurance contract Standard.

Questions to the IASB

Question 1: Does the IASB agree to confirm the proposals in the 2013 ED that, on the initial application of the new insurance contracts Standard:

(a) an entity is permitted to newly designate financial assets under the fair value option as measured at fair value through profit or loss to eliminate (or significantly reduce) an accounting mismatch according to paragraph 4.1.5 of IFRS 9;

(b) an entity is required to revoke previous fair value option designations for financial assets if the accounting mismatch that led to the previous designation according to paragraph 4.1.5 of IFRS 9 no longer exists; and

(c) an entity is permitted to newly designate an investment in an equity instrument as measured at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9 and is permitted to revoke previous designations.

Question 2: In addition, staff are asking if the IASB wishes to consider providing further transition relief to permit or require an entity to reassess the business model for financial assets at the date of initial application of the new insurance contracts Standard. This reassessment would be based on the conditions for assessing the business model in paragraphs 4.1.2(a) or 4.1.2A(a) of IFRS 9 and the facts and circumstances that exist at the date of the first application of the new insurance contracts Standard.

Appendix A: Possible accounting mismatches between financial assets and insurance liabilities

A1. The following tables provide a summary of the possible accounting mismatches that arise between debt instruments and insurance liabilities as follows:

(a) *today*—under IAS 39 and the existing IFRS 4;

(b) After *Change 1(in 2018)*— when IFRS 9 is applied with the existing IFRS 4. This column:

(i) sets out all possible combinations, even though some are unlikely to occur in practice; and

(ii) does **not** reflect that entities may be able to address the accounting mismatches in this period by choosing to apply shadow accounting[6] as permitted by paragraph 30 of IFRS 4 for specified insurance contracts; and

(c) After *Change 2 (after 2018)*— when the new insurance contracts Standard is first applied with IFRS 9.

A2. The existing IFRS 4 permits an entity to continue measuring insurance contracts using existing national GAAPs. At a high level, existing practices measure insurance contracts using either:

(a) Current rates for discounting expected cash flows. This scenario is presented in Table 1; or

(b) Locked-in rates for discounting of the expected cash flows or not discounting the cash flows at all (ie not current rates). This scenario is presented in Table 2.

A3. The table is colour coded as follows:

(a) Green: when (i) there are minimal accounting mismatches under the classification and measurement categories in IAS 39 or IFRS 9; or

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[6] Shadow accounting allows the measurement of the insurance liability to reflect the recognised but unrealised gains and losses of the assets in a similar manner. This includes recognising the changes in the insurance liability in OCI when the unrealised gains and losses of the assets are recognised in OCI. Consequently, entities applying shadow accounting today may be able to address some of the potential accounting mismatches summarised in the table when IFRS 9 is applied.

when (ii) an entity is able to address accounting mismatches by applying the fair value option under IAS 39 or IFRS 9 and/or the presentation options in the new insurance contracts Standard.

(b) Amber: when there are accounting mismatches recognised in OCI and equity.

(c) Red: when there are accounting mismatches recognised in P&L and balance sheet.

A4. Staff note that the analysis can similarly be applied to financial assets other than debt instruments. However, economic mismatches are more significant other than when an entity holds only simple debt instruments and insurance contracts without participation features.

Table 1: Accounting mismatches when insurance liabilities are measured using current discount rates under existing IFRS 4

Today: **(i) Current measure for insurance contracts under IFRS 4** **(ii) Classification of assets under IAS 39**	**Change 1 (in 2018):** **(i) Current measure for insurance contracts under IFRS 4** **(ii) *Classification of assets under IFRS 9*[7]**	**Change 2 (after 2018):** **(i) *Current measure for insurance contracts under new Standard*** **(ii) Classification of assets under IFRS 9**
1. **Held to maturity** (measured at amortised cost) *[Green] Accounting mismatch that can be avoided using FVO for assets.*	a. **Amortised cost** *[Green] Accounting mismatch that can be avoided using FVO for assets.*	a. **Amortised cost** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L and FVO applied to assets.*
	b. **FVOCI** *[Green] Accounting mismatch that can be avoided using FVO for assets.*	b. **FVOCI** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through OCI or using the same options in 1a. above.*
	c. **FVPL** *[Green] No accounting mismatch.*	c. **FVPL** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L.*
2. **Available for sale** (measured at FVOCI) *[Green] Accounting mismatch that can be avoided using FVO for assets.*	a. **Amortised cost** *[Green] Accounting mismatch that can be avoided using FVO for assets.*	a. **Amortised cost** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L and FVO applied to assets.*
	b. **FVOCI** *[Green] Accounting mismatch that can be avoided using FVO for assets.*	b. **FVOCI** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through OCI or using the same options in 2a above.*
	c. **FVPL** *[Green] No accounting mismatch.*	c. **FVPL** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L.*
3. **Held for trading** (measured at FVPL) *[Green] Similar accounting basis – minimal accounting mismatches.*	a. **Amortised cost** *[Green] Accounting mismatch that can be avoided using FVO for assets.*	a. **Amortised cost** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L and FVO applied to assets.*
	b. **FVOCI** *[Green] Accounting mismatch that can be avoided using FVO for assets.*	b. **FVOCI** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through OCI.*
	c. **FVPL** *[Green] No accounting mismatch.*	c. **FVPL** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L.*

[7] The table considers all possible combinations, even though some are unlikely to occur in practice.

Table 2: Accounting mismatches when insurance liabilities are *not* measured using current discount rates under existing IFRS 4

Today: **(i) Cost measure for insurance contracts under IFRS 4** **(ii) Classification of assets under IAS 39**	**Change 1 (in 2018):** **(i) Cost measure for insurance contracts under IFRS 4** **(ii) *Classification of assets under IFRS 9*** [8]	**Change 2 (after 2018):** **(i) *Current measure for insurance contracts under new Standard*** **(ii) Classification of assets under IFRS 9**
1. **Held to maturity** (measured at amortised cost) *[Green] Similar accounting basis – minimal accounting mismatches.*	a. **Amortised cost** *[Green] Similar accounting basis – minimal accounting mismatches.*	a. **Amortised cost** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L and FVO applied to assets.*
	b. **FVOCI** *[Amber] Increased accounting mismatch in OCI and equity.*[9]	b. **FVOCI** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through OCI or using the same options in 1a. above.*
	c. **FVPL** *[Red] Increased accounting mismatch in P&L and equity.*	c. **FVPL** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L.*
2. **Available for sale** (measured at FVOCI) *[Amber] Accounting mismatch in OCI and equity.*	a. **Amortised cost** *[Green] Accounting mismatches reduced.*	a. **Amortised cost** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L and FVO applied to assets.*
	b. **FVOCI** *[Amber] No change.*[9]	b. **FVOCI** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through OCI or using the same options in 2a.*
	c. **FVPL** *[Red] Increased accounting mismatch in P&L and equity.*	c. **FVPL** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L.*
3. **Held for trading** (measured at FVPL) *[Red] Accounting mismatch in P&L and equity*	a. **Amortised cost** *[Green] Accounting mismatches reduced.*	a. **Amortised cost** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L and FVO applied to assets.*
	b. **FVOCI** *[Amber] Accounting mismatches in P&L reduced but remain in OCI and equity.*	b. **FVOCI** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through OCI.*
	c. **FVPL** *[Red] No change.*	c. **FVPL** *[Green] Accounting mismatches can be avoided when accounting policy for insurance contracts is through P&L.*

[8] The table considers all possible combinations, even though some are unlikely to occur in practice.

[9] Entities may be able to address this accounting mismatch by applying shadow accounting (discussed in paragraph A1(b)(ii)).

Appendix B: Relevant extracts from the 2013 ED

Redesignation of financial assets

C11 At the beginning of the earliest period presented, when an entity first applies this [draft] Standard, it is permitted, but not required:

(a) to redesignate a financial asset as measured at fair value through profit or loss if that financial asset meets the condition in paragraph 4.1.5 of IFRS 9, as applicable, at the date when the entity first applies this [draft] Standard.

(b) if the entity has previously applied IFRS 9:

(i) to designate an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9; or

(ii) to revoke a previous designation of an investment in an equity instrument as at fair value through other comprehensive income in accordance with paragraph 5.7.5 of IFRS 9.

C12 An entity is required to revoke previous designations of financial assets as measured at fair value through profit or loss if the initial application of this [draft] Standard eliminates the accounting mismatch that led to that previous designation.

Basis for Conclusion

Redesignation of assets (paragraphs C11–C12)

BC176 The IASB considered whether, upon the first application of these proposals, an entity should be permitted to revisit its elections and designations for financial assets that had previously been designated or classified in accordance with IAS 39 or IFRS 9.[10]

BC177 In the absence of any specific transition relief, any redesignation and/or reclassification would need to be consistent with the financial instruments Standard that the entity applies when it first applies these proposals:

(a) if the entity applies these proposals before it applies any version of IFRS 9, financial assets would be redesignated and/or reclassified in accordance with IAS 39; and

(b) if the entity applies these proposals after it applies a version of IFRS 9, financial assets would be redesignated and/or reclassified in accordance with that version of FRS 9.

BC178 IFRS 9 does not permit either subsequent redesignation under the fair value option or subsequent redesignation of equity instruments into, or out of, the category of instruments at fair value through other comprehensive income. Changes in classification occur only as a result of a change in business model and would not occur because an entity applies a new accounting policy. Furthermore, IFRS 9 states that frequent assertions that an entity has changed its business model would be inconsistent with the IASB’s view that “an entity’s business model does not relate to a choice (ie it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management”.[11]

BC179 The interaction between the classification of financial assets and the presentation of changes in the insurance contract liability would affect the accounting mismatches that would be reported in profit or loss. On first applying the new insurance liability requirements, an entity would be able to reclassify financial assets only in accordance with the requirements in IAS 39 or IFRS 9. However, the IASB proposes that entities would be able to designate financial assets using the fair value option on first applying this proposed Standard to the extent that they would have been able to designate financial assets on first applying IFRS 9. In particular, the IASB proposes that, following earlier application of IFRS 9, an entity would be permitted to newly elect to use other comprehensive income to recognise

[10] IAS 39 and IFRS 9 include requirements for the classification of financial assets. IAS 39 and IFRS 9 also include fair value options for entities to designate financial assets as measured at fair value.

[11] Paragraph BC4.20 of the Basis for Conclusions on IFRS 9.

changes in the fair value of some or all equity investments that are not held for trading, or to revoke such an election. As the criterion for this classification option does not refer to accounting mismatches, the IASB proposes that entities should be able to reconsider this election regardless of whether there is an effect on accounting mismatches. Even though accounting mismatches do not drive this classification option, in practice entities may consider accounting mismatches when deciding whether to apply the option.

Appendix C: Relevant extracts from IFRS 9

Chapter 4 Classification

4.1 Classification of financial assets

4.1.1 Unless paragraph 4.1.5 applies, an entity shall classify financial assets as subsequently measured at amortised cost, fair value through other comprehensive income or fair value through profit or loss on the basis of both:

(a) the entity's business model for managing the financial assets and

(b) the contractual cash flow characteristics of the financial asset.

4.1.2 A financial asset shall be measured at amortised cost if both of the following conditions are met:

(a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions.

4.1.2A A financial asset shall be measured at fair value through other comprehensive income if both of the following conditions are met:

(a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets and

(b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Paragraphs B4.1.1–B4.1.26 provide guidance on how to apply these conditions.

4.1.3 For the purpose of applying paragraphs 4.1.2(b) and 4.1.2A(b):

(a) principal is the fair value of the financial asset at initial recognition. Paragraph B4.1.7B provides additional guidance on the meaning of principal.

(b) interest consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin. Paragraphs B4.1.7A and B4.1.9A–B4.1.9E provide additional guidance on the meaning of interest, including the meaning of the time value of money.

4.1.4 A financial asset shall be measured at fair value through profit or loss unless it is measured at amortised cost in accordance with paragraph 4.1.2 or at fair value through other comprehensive income in accordance with paragraph 4.1.2A. However an entity may make an irrevocable election at initial recognition for particular investments in equity instruments that would otherwise be measured at fair value through profit or loss to present subsequent changes in fair value in other comprehensive income (see paragraphs 5.7.5–5.7.6).

Option to designate a financial asset at fair value through profit or loss

4.1.5 Despite paragraphs 4.1.1–4.1.4, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases (see paragraphs B4.1.29–B4.1.32).

(…)

4.4 Reclassification

4.4.1 When, and only when, an entity changes its business model for managing financial assets it shall reclassify all affected financial assets in accordance with paragraphs 4.1.1–4.1.4. See paragraphs 5.6.1–5.6.7, B4.4.1–B4.4.3 and B5.6.1–B5.6.2 for additional guidance on reclassifying financial assets.

4.4.2 An entity shall not reclassify any financial liability.

4.4.3 The following changes in circumstances are not reclassifications for the purposes of paragraphs 4.4.1–4.4.2:

(a) an item that was previously a designated and effective hedging instrument in a cash flow hedge or net investment hedge no longer qualifies as such;

(b) an item becomes a designated and effective hedging instrument in a cash flow hedge or net investment hedge; and

(c) changes in measurement in accordance with Section 6.7.

(…)

Chapter 5 Measurement

5.7 Gains and losses

5.7.5 Investments in equity instruments

5.7.5 At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of this Standard that is neither held for trading nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 applies.

Appendix B
Application guidance

Option to designate a financial asset or financial liability as at fair value through profit or loss (Sections 4.1 and 4.2)

B4.1.27 Subject to the conditions in paragraphs 4.1.5 and 4.2.2, this Standard allows an entity to designate a financial asset, a financial liability, or a group of financial instruments (financial assets, financial liabilities or both) as at fair value through profit or loss provided that doing so results in more relevant information.

B4.1.28 The decision of an entity to designate a financial asset or financial liability as at fair value through profit or loss is similar to an accounting policy choice (although, unlike an accounting policy choice, it is not required to be applied consistently to all similar transactions). When an entity has such a choice, paragraph 14(b) of IAS 8 requires the chosen policy to result in the financial statements providing reliable and more relevant information about the effects of transactions, other events and conditions on the entity's financial position, financial performance or cash flows. For example, in the case of designation of a financial liability as at fair value through profit or loss, paragraph 4.2.2 sets out the two circumstances when the requirement for more relevant information will be met. Accordingly, to choose such designation in accordance with paragraph 4.2.2, the entity needs to demonstrate that it falls within one (or both) of these two circumstances.

Designation eliminates or significantly reduces an accounting mismatch

B4.1.29 Measurement of a financial asset or financial liability and classification of recognised changes in its value are determined by the item's classification and whether the item is part of a designated hedging relationship. Those requirements can create a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') when, for example, in the absence of designation as at fair value through profit or loss, a financial asset would be classified as subsequently measured at fair value through profit or loss and a liability the entity considers related would be subsequently measured at amortised cost (with changes in fair value not recognised). In such circumstances, an entity may conclude that its financial statements would provide more relevant information if both the asset and the liability were measured as at fair value through profit or loss.

B4.1.30 The following examples show when this condition could be met. In all cases, an entity may use this condition to designate financial assets or financial liabilities as at fair value through profit or loss only if it meets the principle in paragraph 4.1.5 or 4.2.2(a):

(a) an entity has liabilities under insurance contracts whose measurement incorporates current information (as permitted by paragraph 24 of IFRS 4) and financial assets that it considers to be related and that would otherwise be measured at either fair value through other comprehensive income or amortised cost.

(…)

Reclassification (Section 4.4)

Reclassification of financial assets

B4.4.1 Paragraph 4.4.1 requires an entity to reclassify financial assets if the entity changes its business model for managing those financial assets. Such changes are expected to be very infrequent. Such changes are determined by the entity's senior management as a result of external or internal changes and must be significant to the entity's operations and demonstrable to external parties. Accordingly, a change in an entity's business model will occur only when an entity either begins or ceases to perform an activity that is significant to its operations; for example, when the entity has acquired, disposed of or terminated a business line. Examples of a change in business model include the following:

(a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.

(b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

B4.4.2 A change in the objective of the entity's business model must be effected before the reclassification date. For example, if a financial services firm decides on 15 February to shut down its retail mortgage business and hence must reclassify all affected financial assets on 1 April (ie the first day of the entity's next reporting period), the entity must not accept new retail mortgage business or otherwise engage in activities consistent with its former business model after 15 February.

B4.4.3 The following are not changes in business model:

(a) a change in intention related to particular financial assets (even in circumstances of significant changes in market conditions).

(b) the temporary disappearance of a particular market for financial assets.

(c) a transfer of financial assets between parts of the entity with different business models.

Basis for Conclusions

Classification (chapter 4)

Classification of financial assets

BC4.1 In IFRS 9 as issued in 2009 the IASB aimed to help users to understand the financial reporting of financial assets by:

(a) reducing the number of classification categories and providing a clearer rationale for measuring financial assets in a particular way that replaces the numerous categories in IAS 39, each of which has specific rules dictating how an asset can or must be classified;

(b) applying a single impairment method to all financial assets not measured at fair value, which replaces the many different impairment methods that are associated with the numerous classification categories in IAS 39; and

(c) aligning the measurement attribute of financial assets with the way the entity manages its financial assets ('business model') and their contractual cash flow characteristics, thus providing relevant and useful information to users for their assessment of the amounts, timing and uncertainty of the entity's future cash flows.

BC4.2 The IASB believes that IFRS 9 both helps users to understand and use the financial reporting of financial assets and eliminates much of the complexity in IAS 39. The IASB disagrees with the assertion made by a dissenting IASB member that IFRS 9 does not meet the objective of reducing the number of classification categories for financial assets and eliminating the specific rules associated with those categories. Unlike IAS 39, IFRS 9 provides a clear rationale for measuring a financial asset at either amortised cost or fair value, and hence helps users to understand the financial reporting of financial assets. IFRS 9 aligns the measurement attribute of financial assets with the way the entity manages its financial assets ('business model') and their contractual cash flow characteristics. In so doing, IFRS 9 significantly reduces complexity by eliminating the numerous rules associated with each classification category in IAS 39. Consistently with all other financial assets, hybrid contracts with financial asset hosts are classified and measured in their entirety, thereby eliminating the complex and rule-based requirements in IAS 39 for embedded derivatives. Furthermore, IFRS 9 requires a single impairment method, which replaces the different impairment methods associated with the many classification categories in IAS 39. The IASB believes that these changes will help users to understand the financial reporting of financial assets and to better assess the amounts, timing and uncertainty of future cash flows.

(…)

Reclassification

Reclassification of financial assets

BC4.111 The 2009 Classification and Measurement Exposure Draft proposed to prohibit reclassification of financial assets between the amortised cost and fair value categories. The IASB's rationale for that proposal was as follows:

(a) Requiring (or permitting) reclassifications would not make it easier for users of financial statements to understand the information that financial statements provide about financial instruments.

(b) Requiring (or permitting) reclassifications would increase complexity because detailed guidance would be required to specify when reclassifications would be required (or permitted) and the subsequent accounting for reclassified financial instruments.

(c) Reclassification should not be necessary because classification is based on the entity's business model and that business model is not expected to change.

BC4.112 In their responses, some users questioned the usefulness of reclassified information, noting concerns about the consistency and rigour with which any requirements would be applied. Some were also concerned that opportunistic reclassifications would be possible.

BC4.113 However, almost all respondents (including most users) argued that prohibiting reclassification is inconsistent with a classification approach based on how an entity manages its financial assets. They noted that in an approach based on an entity's business model for managing financial assets, reclassifications would provide useful, relevant and comparable information to users because it would ensure that financial statements faithfully represent how those financial assets are managed at the reporting date. In particular, most users stated that, conceptually, reclassifications should not be prohibited when the classification no longer reflects how the instruments would be classified if the items were newly acquired. If reclassification were prohibited, the reported information would not reflect the amounts, timing and uncertainty of future cash flows.

BC4.114 The IASB was persuaded by these arguments and decided that reclassification should not be prohibited. The IASB noted that prohibiting reclassification decreases comparability for like instruments managed in the same way.

BC4.115 Some respondents contended that reclassifications should be permitted, instead of required, but did not explain their justification. However, the IASB noted that permitting reclassification would decrease comparability, both between different entities and for instruments held by a single entity, and would enable an entity to manage its profit or loss by selecting the timing of when future gains or losses are recognised. Consequently, the IASB decided that reclassification should be required when the entity's business model for managing those financial assets changes.

BC4.116 The IASB noted that, as highlighted by many respondents, such changes in business model would be very infrequent, significant and demonstrable and determined by the entity's senior management as a result of external or internal change.

BC4.117 The IASB considered arguments that reclassification should also be permitted or required when contractual cash flow characteristics of a financial asset vary (or may vary) over that asset's life based on its original contractual terms. However, the IASB noted that, unlike a change in business model, the contractual terms of a financial asset are known at initial recognition. An entity classifies the financial asset at initial recognition on the basis of the contractual terms over the life of the instrument. Consequently, the IASB decided that reclassification on the basis of a financial asset's contractual cash flows should not be permitted.

BC4.118 The IASB considered how reclassifications should be accounted for. Almost all respondents said that reclassifications should be accounted for prospectively and should be accompanied by robust disclosures. The IASB reasoned that if classification and reclassification are based on the business model within which they are managed, classification should always reflect the business model within which the financial asset was managed at the reporting date. To apply the reclassification retrospectively would not reflect how the financial assets were managed at the prior reporting dates.

BC4.119 The IASB also considered the date at which reclassifications could take effect. Some respondents stated that reclassifications should be reflected in the entity's financial statements as soon as the entity's business model for the relevant instruments changes. To do otherwise would be contradictory to the objective of reclassification—ie to reflect how the instruments are managed. However, the IASB decided that reclassifications should take effect from the beginning of the following reporting period. In the IASB's view, entities should be prevented from choosing a reclassification date to achieve an accounting result. The IASB also noted that a change in an entity's business model is a significant and demonstrable event; therefore, an entity will most likely disclose such an event in its financial statements in the reporting period in which the change in business model takes place.

BC4.120 The IASB also considered and rejected the following approaches:

(a) *Disclosure approach*: Quantitative and qualitative disclosure (instead of reclassification) could be used to address when the classification no longer reflects how the financial assets would be classified if they were newly acquired. However, in the IASB's view, disclosure is not an adequate substitute for recognition.

(b) *One-way reclassification*: Reclassification would be required only to fair value measurement, ie reclassification to amortised cost measurement would be prohibited. Proponents of this approach indicated that such an approach might minimise abuse of the reclassification requirements and result in more instruments being measured at fair value. However, in the IASB's view, there is no conceptual reason to require reclassification in one direction but not the other.