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Introduction

1. This paper provides background to Agenda Paper 2B *Addressing the consequences of different effective dates of IFRS 9 and the new insurance contracts Standard: IFRS 4 approaches*. This paper describes the accounting consequences that could arise when an entity that issues contracts within the scope of IFRS 4 applies IFRS 9 *Financial Instruments* together with IFRS 4 *Insurance Contracts*. Agenda Paper 2B considers how those consequences could be addressed within the context of IFRS 4, either through existing options in IFRS 4, or by modifying IFRS 4. As described in paragraphs 24-25, the staff are continuing to explore other approaches to addressing the consequences identified in this paper, including approaches based on the deferral of the effective date of IFRS 9 for some entities that issue contracts within the scope of IFRS 4. However, to assist the IASB in addressing the consequences arising from different effective dates of IFRS 9 and the new insurance contracts Standard expeditiously, the staff are exploring several approaches concurrently.

2. This paper does not ask the IASB for decisions.

Consequences of applying IFRS 9 before applying the new insurance contracts Standard and approaches to addressing those consequences

Temporary accounting mismatches and volatility

3. In January 2015 and June 2015, the IASB noted that some insurers are concerned that there are circumstances in which the application of IFRS 9 would result in some financial assets held by insurers being classified at fair value through profit or loss (FVPL), when those assets are classified at amortised cost or as available-for-sale (AFS) under IAS 39 *Financial Instruments: Recognition and Measurement*. Such financial assets could include debt investments that do not have payments that are 'solely payments of principal and interest' and equity investments to which an entity does not choose to apply the OCI presentation option.

4. When financial assets are classified at FVPL, the consequences are:

    (a) accounting mismatches could arise in profit or loss if insurance contract liabilities are measured on a cost basis (eg using a locked-in discount rate). That would be the case under both IAS 39 and IFRS 9. However, some stakeholders are concerned that those effects will increase when IFRS 9 is applied in combination with IFRS 4 for the reasons stated in paragraph 3. The staff consider separately the accounting mismatches that arise:

        (i) In respect of contracts for which some or all the gains and losses on the entity's assets have a direct effect on the measurement of the insurance contracts (ie some participating contracts). For such contracts, differences in the measurement of liabilities and underlying assets would give rise to an accounting mismatch.

        (ii) in respect of contracts for which gains and losses on the entity's assets do not have a direct effect on the measurement of the insurance contracts. Such contracts include non-life and non-participating life contracts, collectively referred to in these papers as 'non-participating contracts'. It would also include participating life contracts for which gains and losses on the entity's assets have an

indirect effect on the measurement of the insurance contracts. For such contracts, differences in the measurement of assets and liabilities may give rise to an accounting mismatch (different effect of changes in the time value of money), but it would also reflect an economic mismatch (differences in risk profile) between assets and liabilities, or a combination of both. Such economic mismatch would persist after the application of the new insurance contracts Standard.

(b) volatility could arise in profit or loss relating to the shareholder's interest in financial assets measured at FVPL that underlie contracts with direct participation features. Such volatility in profit or loss would not arise under the new insurance contracts Standard for contracts with direct participation features because of the IASB's tentative decision that an entity should apply the variable fee approach to such contracts. We refer to such volatility in this paper as "temporary volatility".

5. The staff are exploring the extent to which the some of the consequences identified in paragraph 4 could potentially be addressed through either, or both:

(a) amendments to IFRS 4; and/or

(b) deferral of the effective date of IFRS 9 for some entities that issue contracts within the scope of IFRS 4.

6. Accordingly, Agenda Paper 2B *Addressing the consequences of different effective dates of IFRS 9 and the new insurance contracts Standard: IFRS 4 approaches* for this meeting explores the extent to which the consequences identified in paragraph 4 could potentially be addressed through the existing requirements in IFRS 4 or through amending those requirements. In particular, Agenda Paper 2B considers the extent to which reporting entities can reduce additional accounting mismatches and temporary volatility in profit or loss that would otherwise arise on application of IFRS 9 before the new insurance contracts Standard by applying the flexibility in IFRS 4, and also recommends changes to IFRS 4 that would enable reporting entities to reduce those effects further.

7. In addition the staff are still analysing the approaches that could address the consequences identified in paragraph 4 through the deferral of the effective date

of IFRS 9 for some entities that issue contracts within the scope of IFRS 4, and the consequences of such approaches. The staff plan to ask the IASB to consider that analysis at a future meeting.

Consequences the IASB has yet to consider

8. Through targeted outreach, the staff noted the following consequences of the different effective dates of IFRS 9 and the new insurance contracts Standard, which are not considered in the papers for this meeting:

   (a) *Temporary application of the new impairment requirements required by IFRS 9*

   IFRS 9 requires some assets to be classified as amortised cost or FVOCI based on the contractual cash flow characteristics and the business model assessment. Some entities note that they expect to invoke the fair value option for these assets on initial application of the new insurance contracts Standard[1]. This is because the application of that Standard will create an accounting mismatch in profit or loss between the cost measure of financial assets and the current measure of the insurance contract liabilities. However, when those assets are used to back insurance contracts measured at cost under IFRS 4, there is no accounting mismatch and therefore the entity would not be able to invoke the fair value option for such assets when IFRS 9 is initially applied unless the entity changes its accounting policy for insurance contracts liabilities under IFRS 4 to reflect current interest rates. Accordingly, without such a change in accounting policy, such entities would incur the costs of building a system to apply the impairment

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[1] In January 2015, the IASB tentatively confirmed the transition relief proposals in the 2013 Exposure Draft that, on the initial application of the new insurance contracts Standard:

- 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 in accordance with paragraph 4.1.5 of IFRS 9;
- an entity is required to revoke previous fair value option designations for financial assets if the accounting mismatch that led to the previous designation in accordance with paragraph 4.1.5 of IFRS 9 no longer exists; and
- 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.

requirements for the period when IFRS 9 is applied in conjunction with IFRS 4. However, these systems would no longer be required when the new insurance contracts Standard is applied.

(b) *Need to explain changes to accounting twice*

Some preparers note that the initial application of IFRS 9 and IFRS 4 on different dates would make it difficult for entities to explain the effects of two consecutive sets of accounting changes in a short period of time. In contrast, some preparers think that those two consecutive sets of accounting changes could make it easier to explain separately the effects of each accounting change.

The staff notes that any approach the IASB might consider developing in order to mitigate the consequences of different effective dates would require explanation of the effects to users of financial statements. This would especially be the case if those approaches were optional, rather than required. For example:

(i) If the IASB were to decide to defer the effective date of IFRS 9 for some, but not all, financial assets held by an entity, the entity would need to explain to which assets any such deferral is applied and the basis for the entity applying such a deferral. The entity would also need to quantify and explain the effects of such a deferral. In the light of the IASB's discussion in June, the staff expect that entities would be required to provide comprehensive disclosures to allow for a reasonable comparison between entities that apply IFRS 9 and those that do not.[2] The entity would later have to explain the effects of applying IFRS 9 and the new insurance contracts Standard.

(ii) If the IASB were to amend IFRS 4, the entity would need to quantify and explain the effect of applying the amendments to IFRS 4, and later the effect of applying the new insurance contracts Standard.

[2] Paragraph 30(c) of IAS 8 requires that an entity disclose "known or reasonable estimable information relevant to assessing the possible impact that application of the new IFRS will have on the entity's financial statements in the period of initial application."

Accordingly, the staff conclude that all approaches would require detailed explanation and all would risk causing confusion for users of financial statements.

(c) *Costs of implementing two changes in accounting consecutively*

Some preparers stated they are concerned about the costs of implementing two consecutive sets of accounting changes in a short period of time, for example, because it might cause them to have to revisit[3] the decisions they made on initial application of IFRS 9 when they later implement the new insurance contracts Standard. In contrast, other preparers stated that two consecutive sets of accounting changes is a better approach than applying all those changes at the same time. This is because consecutive changes would enable them to spread the same resource needed for implementation by using those resources over a longer time.

(d) *Extent to which consequences identified are temporary*

Many expect that there will be a relatively short period of time between the effective dates of IFRS 9 and the new insurance contracts Standard (generally assumed to be two years or less). Some argue that if the period of time between those dates were longer, then the argument that users of financial statements could be confused by two changes in accounting in a short period of time would be less valid because the period of time would no longer be short. At the same time, the costs of any delay in the application of IFRS 9 to financial assets to users of financial statements would increase because they would not have comparable information about financial instruments. Accordingly, some suggest the IASB should set a time limit for any amendments it might decide to propose.

9. The staff plan to consider whether and how these issues should be addressed.

[3] In January 2015, the IASB tentatively decided 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.

Addressing additional accounting mismatches and temporary volatility in profit or loss – common themes for different approaches

10. The staff observe that there is a wide range of diverse practice in the way that entities apply IFRS 4. For many entities those diverse practices can already result in accounting mismatches, given that assets are measured using a mixed measurement model. When such accounting mismatches arise today, entities provide explanations to users of financial statements using a variety of communication tools.

11. If the IASB were to address the some of the additional temporary accounting mismatches and temporary volatility described in paragraph 4, the staff note that the most desirable outcome would be an approach that:

    (a) Targets only the consequences relating to any additional temporary accounting mismatches or temporary volatility arising from the shareholders’ interest in underlying items introduced by applying IFRS 9 in conjunction with the existing IFRS 4 but does not mask true economic volatility that would continue to be reflected in profit or loss when the new insurance contracts Standard is applied (see paragraphs 12-15);

    (b) Would not require extensive operational change that is not needed to apply IFRS 9 or the forthcoming insurance contracts Standard, and can be easily explained to, and understood by, users of financial statements as a temporary measure to address any consequences of different effective dates for IFRS 9 and the new insurance contracts Standard; (discussed in Agenda Paper 2B);

    (c) Minimises the risk that entities would continue to apply IAS 39 to assets that are not related to insurance contracts the entity issues, in particular assets that are related to contracts issued as a result of banking activities (see paragraphs 16-17);

    (d) Results in comparable information about all financial instruments held by reporting entities that is useful to users of financial statements (see paragraphs 18-21); and

(e) Can be finalised expeditiously by the IASB so that entities could be provided with certainty and clarity as soon as possible (see paragraphs 22-23).

Targeted approaches

12. IFRS 4 addresses the accounting requirements for insurance contracts and is applied by entities that issue such contracts. In contrast, IFRS 9 sets out accounting requirements for financial assets and will be applied by all entities to all their financial assets. The consequences that interested parties have asked the IASB to consider arise from the interaction between accounting for insurance contracts liabilities and related financial assets. It is therefore difficult for the IASB to target approaches to address only the identified consequences for specific entities. This would be the case both for approaches that amend IFRS 4 and for approaches that defer IFRS 9.

13. In order to ensure that any approaches are appropriately targeted their scope must be carefully considered, including the following questions:

    (a) Which entities should be allowed to apply any amendment to IFRS 4 or any deferral of the effective date of IFRS 9?

    (b) Should any amendment to IFRS 4 or deferral of the effective date of IFRS 9 apply to all or only some financial assets held by entities that are eligible to apply those amendments? In particular:

        (i) It is relatively simple to identify the assets backing participating contracts. Such assets could be identified using the existing criteria for eligibility for shadow accounting in IFRS 4.

        (ii) However, as described in paragraph 4(a)(ii), consequences also arise for non-participating contracts. For such contracts, it would be difficult to identify related assets in a robust and non-arbitrary way.

14. The staff observe that the answers to these questions may depend on the nature of the amendment to IFRS 4 or extent of any deferral of the effective date of IFRS 9. In particular, the degree of precision needed in specifying the scope of any

approach depends on the extent to which the approach is targeted at the issue addressed. For example:

(a) Approaches that introduce more complexity for users of financial statements and have effects that are more difficult to explain, would require a more robust scope than those that introduce less complexity. It may also be necessary to limit the scope of such approaches to reduce the complexity in financial statements.

(b) Approaches that rely on subjective information based on management intent would require a more robust and limited scope that those that rely on objective, observable information.

(c) Approaches that mask economic effects, even in the short term, by reducing volatility resulting from economic mismatches that would be reported in profit or loss when IFRS 9 and the new insurance contracts Standard are applied would require a more robust and limited scope than those that do not.

15. The staff also observe that some suggest that the IASB should defer the effective date of IFRS 9 for the same financial assets for which an entity would be permitted to reassess the business model on implementing IFRS 4.[4] However, the staff note that a different scope for reassessment of the business model and any deferral may be needed. This is because the transition relief relating to the reassessment of the business model addresses situations in which the entity reaches a different conclusion about its business model for managing financial assets based on the new set of facts and circumstances that exists when the new insurance contracts Standard is applied. It is a reaction to a determinable change in circumstances that leads to a different conclusion, and consequently is self-limiting.

[4] In January 2015, the IASB tentatively decided 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

Risk that entities would continue to apply IAS 39 to assets unrelated to insurance contracts

16. IFRS 9 is a significant improvement in accounting for financial instruments that has been subject to extensive due process and is relevant for all entities that hold and issue financial instruments. It is important that those improvements are applied on a timely basis. Improved classification and measurement requirements in IFRS 9 will better portray how entities manage their financial assets. In addition, timely application of IFRS 9 provides the benefit of improved accounting and disclosure in respect of expected credit losses, an improved hedge accounting model and associated disclosures about risk management.

17. Accordingly, some IASB members indicated in the June 2015 education session that it would be undesirable to permit entities to continue to apply IAS 39 to assets unrelated to insurance contracts, especially if the scope is not targeted to temporary additional accounting mismatches that would be addressed by applying the new insurance contracts Standard.

Comparable information about financial instruments held by reporting entities

18. The improvements in IFRS 9 are relevant for entities that issue contracts within the scope of IFRS 4 because these entities hold significant investments in financial instruments. Accordingly, while noting feedback from insurers that simultaneous application of IFRS 9 and the new insurance contracts Standard was most desirable, the IASB previously concluded that timely application of IFRS 9 for all entities was needed. The IASB noted that if the mandatory effective date of IFRS 9 for entities that issue contracts within the scope of IFRS 4 was dependent on the timing of the new insurance contracts Standard it could result in:

    (a) impaired comparability of the financial statements of entities that issue contracts within the scope of IFRS 4 and entities that do not; and

    (b) the creation of an arbitrary line for entities that have both insurance and other types of business.

19. Furthermore, if the IASB were to make any deferral of IFRS 9 optional, there could be impaired comparability between entities that issue contracts within the

scope of IFRS 4 that choose to apply any deferral and those that do not. As noted at the March ASAF meeting, entities in some jurisdictions have indicated they wish any relief to be optional which indicates that they may not use it.

20. To reduce the effect of this impaired comparability, and because IFRS 9 is a significant improvement, some IASB members proposed (at the June 2015 meeting) that, under any approach, entities should be required to present information about the effects of applying IFRS 9 to financial instruments within the scope of IFRS 9 even if those entities choose to apply any deferral of the effective date of IFRS 9.

21. The staff plan to conduct outreach with investors to understand the effects of various approaches, including the disclosure that would be needed to help users of financial statements understand the resulting information. The staff will then further develop disclosure proposals for a discussion at a future IASB meeting, if necessary.

Expeditious standard setting

22. The staff note that any approach to address the consequences relating to the different effective dates on IFRS 9 and the new insurance contracts Standard would require an amendment to existing IFRS. Accordingly, any such change would be subject to the IASB's minimum due process procedure that ensures that the IASB's activities benefit from a thorough and effective consultation process. The IASB normally allows a minimum period of 120 days for comment on an Exposure Draft. The Due Process handbook states that if the matter is narrow in scope and urgent, the IASB may consider a comment period of no less than 30 days, but it will only set a period of less than 120 days after consulting, and obtaining approval from, the Due Process Oversight Committee.

23. The staff remind the IASB that more complex requirements generally require a greater number of IASB meetings to debate the issues for exposure, as well as more time for interested parties to consider and comment on the proposals, and for the staff to analyse comment letters and assist the IASB in redeliberating the proposals.

Next steps

24. To assist the IASB in addressing the consequences that could arise for some entities from different effective dates of IFRS 9 and the new insurance contracts Standard expeditiously, the staff are exploring several approaches concurrently. In assessing those approaches, the staff will place weight on the extent to which each approach provides useful financial information to users of financial statements during the period between the effective dates of those Standards.

25. The staff expect to continue to explore approaches to addressing the consequences identified in this paper, including approaches based on the deferral of the effective date of IFRS 9 for some entities that issue contracts within the scope of IFRS 4. The staff note that there may be a need to consider permitting more than one approach (eg a combination of asset and liability based approaches), given the difficulties in precisely targeting any approaches and the different circumstances affecting reporting entities. Any individual approach might only apply to some, but not all, situations in which any individual issue arises. For example, if the IASB were to decide to permit deferral of the effective date of IFRS 9 for entities with a high proportion of contracts within the scope of IFRS 4, then some entities that issue less than a high proportion of contracts within the scope of IFRS 4 would not be able to reduce those effects, even though they also have the temporary increase in accounting mismatches or temporary volatility in profit or loss as described in this paper. Similarly, different entities may reach different conclusions based on their particular circumstances about which approach would be more cost effective, less complex and/or provide more relevant financial information for users of their financial statements.