STAFF PAPER

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REG IASB Meeting

Project	**Insurance Contracts**
Paper topic	Application of IFRS 9 *Financial Instruments* before the new insurance contracts Standard

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Purpose of the paper

1. This paper provides the context for:

   (a) Agenda Paper 2F *Use of IFRS 4* Insurance Contracts *to address the consequences of applying IFRS 9* Financial Instruments *before the new insurance contracts Standard*, and

   (b) Agenda Paper 2G *The complexity of deferring the effective date of IFRS 9* Financial Instruments *for the insurance industry*.

2. This paper discusses feedback on applying IFRS 9 prior to applying the new insurance contracts Standard and provides staff observations about the issues raised. It is for information only.

Feedback

3. As stated in Agenda Paper 2F of May 2015, at the March 2015 meeting of the Accounting Standards Advisory Forum (ASAF), a representative of the European Financial Reporting Advisory Group (EFRAG) requested the IASB to reconsider its position to not defer the effective date of IFRS 9 for entities that issue insurance contracts. The representative stated EFRAG's view that applying IFRS 9 prior to applying the new insurance contracts Standard could create disruption for users of financial statements who follow entities that issue insurance contracts,

and make it more difficult to understand the financial position and performance of insurance businesses.

4. In May 2015, EFRAG issued draft endorsement advice (DEA) for the use of IFRS 9 in the European Union. In the DEA, EFRAG recommended IFRS 9 for endorsement but also expressed a view that applying IFRS 9 prior to applying the new insurance contacts Standard may disrupt the financial reporting of insurance activities, which will make financial reporting less understandable for users of financial statements while increasing costs for preparers. Consequently, EFRAG proposed in the DEA that the European Commission should ask the IASB to defer the effective date of IFRS 9 for insurance businesses and align it with the effective date of the new insurance contracts Standard.

5. However, EFRAG emphasised in the DEA that its preliminary position on the deferral of IFRS 9 for insurance businesses is subject to further in-depth understanding of the potential effects of applying IFRS 9 prior to applying the new insurance contracts Standard and asked constituents to provide more evidence and insights on this issue. The DEA is open for comment until 30 June 2015.

6. Although feedback relating to applying IFRS 9 prior to applying the new insurance contracts Standard has been primarily driven by interested parties in Europe, there have been indications from some interested parties in other jurisdictions that they have similar concerns.

7. At the same time, other interested parties both from Europe and other jurisdictions expressed a view that IFRS 9 should be applied without delay, including by entities that issue insurance contracts. They also indicated that any temporary measures proposed to address concerns raised—*if* the IASB were to consider such measures—should be optional rather than mandatory in order:

   (a) not to create disruption for entities that have already started implementing, or have implemented, IFRS 9;

   (b) not to delay the improved accounting for financial instruments under IFRS 9 for a broad range of entities, including entities that issue insurance contracts and that do not have concerns about applying IFRS 9; and

(c) not to impose the additional operational burden of any temporary measures on a broad range of entities, including entities that issue insurance contracts and that do not have concerns about applying IFRS 9.

8. The staff have been monitoring the developments on this issue and have conducted targeted outreach with interested parties to better understand the issues that could arise for the insurance industry if IFRS 9 is applied before the new insurance contracts Standard is applied. The staff understand that the common concerns include:

(a) A temporary increase in accounting mismatches and other sources of volatility in profit or loss (discussed in Agenda Paper 2F) created by the change in the classification of financial assets when IFRS 9 is applied without a change to the accounting for insurance liabilities at the same time, and

(b) The need to undergo two consecutive sets of accounting changes in a short period of time, ie application of IFRS 9 followed by application of the new insurance contracts Standard, which could create confusion for users of financial statements and would result in more cost and effort for both preparers and users of financial statements.

Staff observations

9. The staff acknowledge concerns described in paragraph 8. However, the staff think that any drawbacks of applying IFRS 9 prior to applying the new insurance contracts Standard should be carefully weighed against both:

(a) the benefits of the timely implementation of IFRS 9 by all entities that hold financial instruments, including entities that issue insurance contracts, and

(b) the drawbacks of deferring the effective date of IFRS 9 for entities (or parts of entities) that issue insurance contracts.

10. In addition, the staff believe that other approaches could be explored in order to mitigate the concerns about the temporary increase in accounting mismatches and

other sources of volatility in profit or loss for entities that issue insurance contracts and the resulting impact on comparability and understandability of their financial statements.

11. The staff note that 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 implemented on a timely basis. Arguably, this is particularly true for entities that issue insurance contracts because they hold significant investments in financial instruments. For example, timely implementation of the new impairment requirements in IFRS 9 and related disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* will better reflect the credit quality of insurers' investment portfolios and provide better information about credit risk and how it is managed. Improved classification and measurement requirements in IFRS 9 will better portray how insurers manage their financial assets. In addition, timely application of IFRS 9 provides the benefit of improved accounting that addresses the issue of 'own credit risk' for financial liabilities measured under the fair value option and improved hedge accounting model and associated disclosures about risk management.

12. The staff also note that the IASB faced a similar issue when it developed existing IFRS 4 and considered whether and how to address mismatches caused by different measurement bases for financial assets and insurance liabilities. At that time, the question arose whether accounting for financial assets under IAS 39 *Financial Instruments: Recognition and Measurement* needed to be amended (rather than deferred) to address the interaction with insurance contracts liabilities. Paragraph 174 of the Basis for Conclusions on IFRS 4 states:

> In the light of these considerations, the Board concluded that changing the measurement requirements in IAS 39 for financial assets, even temporarily, would diminish the relevance and reliability of an insurer's financial statements. The Board observed that the accounting mismatch arose more from imperfections in existing measurement models for insurance liabilities than from deficiencies in the measurement of the assets. It would

have been a retrograde step to try to mitigate the accounting mismatch by adopting a less relevant measurement of the assets—a measurement that would also have obscured some of the economic mismatch.

13. The staff think that similar considerations apply to the present situation. That is, delaying application of the improved accounting in IFRS 9 for financial assets could diminish the relevance of the financial statements of the entities that issue insurance contracts, even if that improved accounting for financial assets results in a temporary increase in accounting mismatches due to the imperfections of the current accounting for insurance contracts liabilities.

14. The staff think that, in principle, any temporary increase in accounting mismatches and other sources of volatility in profit or loss that arise from the application of IFRS 9 prior to the application of the new insurance contracts Standard could be addressed on either side of the balance sheet—*if* the IASB decides that such mismatches or other sources of volatility in profit or loss need to be addressed. In other words, such mismatches could be addressed:

    (a) On the liability side, ie by exploring accounting policy options available under IFRS 4 today, or permitting additional options (discussed in Agenda Paper 2F), or

    (b) On the asset side, ie by deferring the effective date of IFRS 9 for entities (or parts of entities) that issue insurance contracts (discussed in Agenda Paper 2G).

15. Alternatively, the staff note that any temporary increase in accounting mismatches and other sources of volatility in profit or loss could also be *explained* using enhanced presentation and disclosure in financial statements, similar to how existing accounting mismatches and other sources of volatility in profit or loss are explained today.

16. The staff acknowledge that the concerns raised about the application of IFRS 9 prior to the application of the new insurance contracts Standard do not relate only to specific accounting issues. Rather, there are also concerns that two sets of consecutive accounting changes in a short period of time will result in added costs and complexity for both preparers and users of financial statements as well as

confusion for users of financial statements. However, the staff note that addressing those concerns by deferring the effective date of IFRS 9 could, in turn, create a different set of added costs and complexities for both preparers and users of financial statements as well as create confusion for users of financial statements. This is because deferring the effective date of IFRS 9 for entities (or parts of entities) that issue insurance contracts standards could, as discussed in Agenda Paper 2G:

(a) require new accounting guidance that could be complex and create operational challenges for preparers (for example, the need to track where in the reporting entity a financial asset was initially recognised) and confusion for users of financial statements (for example, if both IAS 39 and IFRS 9 were simultaneously applied by a single reporting entity),

(b) reduce comparability in the accounting for financial instruments, including within a single reporting entity depending on the specific requirements of the deferral, that likely would need to be mitigated by enhanced disclosures (for example, of the carrying amounts that would have been determined under IFRS 9), which would put an extra burden on preparers;

(c) Create a risk of earnings management if both IAS 39 and IFRS 9 were simultaneously applied within one reporting entity (for example, depending on the specific deferral requirements, a reporting entity could cherry-pick either where to originate financial assets or where to transfer those assets to achieve a particular accounting outcome).

17. In addition, deferring the effective date of IFRS 9 would still involve two consecutive sets of accounting changes, ie the application of the deferral guidance (that could include the application of IFRS 9 to some, but not all, financial assets held by the reporting entity) followed by the application of IFRS 9 to the remaining financial assets in conjunction with the application of the new insurance contracts Standard.

18. Therefore, the staff think it is important to consider carefully the implications of the difference in timing of the application of IFRS 9 and the application of the

new insurance contracts Standard relative to the implications of various approaches that could be pursued in response to the concerns raised by interested parties. It is also important to weigh the benefits and the challenges of each approach, including the time and effort required to develop and implement some of the approaches, relative to the temporary nature of the specific accounting issues raised.