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STAFF PAPER

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Project	**Different effective dates of IFRS 9 and the new insurance contracts Standard**
Paper topic	The Overlay Approach

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This paper has been prepared for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Purpose of this paper

1. This paper considers when and how an entity may adjust profit or loss and other comprehensive income (OCI) to remove from profit or loss the effect of newly measuring financial assets at fair value through profit or loss (FVPL) in accordance with IFRS 9 *Financial Instruments*. That adjustment is referred to as 'the overlay adjustment'. An entity that makes an overlay adjustment is said to apply 'the Overlay Approach'.

Background

2. The IASB tentatively decided at its July 2015 meeting to amend IFRS 4 *Insurance Contracts* to permit some entities to remove from profit or loss and recognise in OCI the difference between (i) the amounts recognised in profit or loss in accordance with IFRS 9 and (ii) the amounts that would have been recognised in profit or loss in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* for specified financial assets. In doing this, an entity applies IFRS 9 in full but makes the adjustment described above in profit or loss and OCI:

    (a) in relation to financial assets that:

        (i) were previously, or would have been, classified at amortised cost or as available-for-sale (AFS) in accordance

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with IAS 39 and are classified in accordance with IFRS 9 at fair value through profit or loss (FVPL); and

(ii) relate to insurance activities;

(b) provided that the entity:

(i) issues contracts accounted for under IFRS 4; and

(ii) applies IFRS 9 in conjunction with IFRS 4.

3. The IASB noted that it would consider further how to identify the assets to which such an adjustment would apply, any additional disclosures and the requirements that would need to apply when those assets are transferred within a group.

Staff recommendations

4. The staff recommend that:

Financial assets eligible for the overlay adjustment (eligible financial assets)

(a) An entity is permitted to make an overlay adjustment in respect of financial assets that meet both of the following criteria:

(i) the financial assets are designated by the entity as relating to contracts that are within the scope of IFRS 4[1]; and

(ii) the financial assets are classified as FVPL in accordance with IFRS 9 and would not have been classified as FVPL in accordance with IAS 39.

(b) An entity may change the designation of financial assets as relating to contracts within the scope of IFRS 4 only if there is a change in the relationship between the financial assets and contracts that are within the scope of IFRS 4.

Redesignation of financial assets

(c) An entity applies the Overlay Approach prospectively to financial assets when the eligibility criteria are met; and

[1] The meaning of the term 'assets relating to contracts within the scope of IFRS 4' is discussed in paragraphs 10 to 17

(d) an entity ceases applying the Overlay Approach when financial assets no longer meet the eligibility criteria. Any accumulated balance of OCI relating to the overlay adjustment should be immediately reclassified to profit or loss (recycled).

Transition

(e) An entity is permitted to apply the Overlay Approach only when it first applies IFRS 9, including if it chooses to apply IFRS 9 early;

(f) an entity should apply the Overlay Approach retrospectively to eligible financial assets on transition to IFRS 9. The entity should recognise as an adjustment to the opening balance of OCI an amount equal to the difference between the fair value of financial assets and their amortised cost or cost carrying amount determined in accordance with IAS 39 immediately prior to transition to IFRS 9;

(g) an entity should restate comparative information to reflect the Overlay Approach only if the entity also restates that comparative information in accordance with IFRS 9;

(h) an entity should stop applying the Overlay Approach when it applies the new insurance contracts Standard and is permitted to stop applying the Overlay Approach in any reporting period; and

(i) when an entity stops applying the Overlay Approach it should reclassify any balance of the prior periods' overlay adjustments accumulated in OCI to retained earnings as of the beginning of the earliest reporting period presented.

Presentation of the overlay adjustment in the statement of comprehensive income

(j) When an entity applies an overlay adjustment it should present a single line item for the amount of the overlay adjustment in the profit or loss or the OCI sections of the statement of comprehensive income or both.

Disclosure

(k) When an entity applies an overlay adjustment, it should disclose the following:

(i) the fact that the entity has made an overlay adjustment, and the financial assets to which the overlay adjustment relates;

(ii) the entity's policy for determining the financial assets for which an overlay adjustment is made;

(iii) an explanation of the amount of the total overlay adjustment in each period in a way that enables users of the financial statements to understand how it is derived. In particular, an entity should disclose the following in respect of intra-group transfers and re-designation of financial assets:

1. the amount of overlay adjustment in profit or loss and OCI relating to financial assets newly within the scope of the Overlay Approach
2. the amount of overlay adjustment that would have arisen in profit or loss and OCI in a period if financial assets had not been removed from the scope of the Overlay Approach
3. the amount of overlay adjustment due to reclassification of amounts in accumulated OCI to profit or loss in respect of financial assets removed from the scope of the Overlay Approach; and

(iv) the effect of the overlay adjustment line items in the profit or loss section of the statement of comprehensive income if this information is not presented on the face of the profit or loss section of the statement of comprehensive income.

Structure of this paper

5. This paper is structured as follows:

(a) Financial assets eligible for the overlay adjustment (paragraphs 7 to 23)

(b) The accounting treatment when the overlay adjustment is newly applied or ceases to apply to financial assets in a reporting period (paragraphs 24 to 36)

(c) Transition by entities to and from applying the Overlay Approach (paragraphs 37 to 45)

(d) Presentation of line items in the statement of comprehensive income when there is an overlay adjustment (paragraphs 46 to 51)

(e) Disclosures required when there is an overlay adjustment (paragraphs 52 and 53).

(f) Operational implications of the Overlay Approach (paragraphs 54 to 57)

6. Appendices:

(a) Appendix A describes how the overlay adjustment is determined.

(b) Appendix B contains illustrative examples of the Overlay Approach in a range of scenarios

Financial assets eligible for the overlay adjustment

7. At the July 2015 meeting, the IASB tentatively decided that an overlay adjustment should be limited to financial assets that:

(a) were previously, or would have been, classified at amortised cost or as available-for-sale (AFS) in accordance with IAS 39 and are classified in accordance with IFRS 9 at fair value through profit or loss (FVPL); and

(b) relate to insurance activities

8. This section:

(a) clarifies the staff's intent that the overlay adjustment should apply to financial assets that are classified in accordance with IFRS 9 at FVPL that were not previously classified at FVPL in accordance with IAS 39

(b) clarifies which financial assets should be considered to 'relate to insurance activities'; and

(c) explains why the staff considered but rejected proposals to further limit the circumstances in which the overlay adjustment would apply.

Financial assets that are classified as FVPL in accordance with IFRS 9 and would not be classified as FVPL in accordance with IAS 39

9. The July 2015 tentative decision referred to financial assets classified at amortised cost and AFS in accordance with IAS 39 that are reclassified to FVPL in accordance with IFRS 9. That decision did not refer to investments in equity instruments (or physically settled derivatives over such equity instruments) measured at cost in accordance with the cost exemption in paragraph 46(c) of IAS 39. The staff note however that the concerns considered by the Board in July are similar for any assets that were not classified at FVPL in accordance with IAS 39, but will be so classified under IFRS 9. Accordingly, the staff propose that the overlay adjustment should be permitted for all financial assets that are classified in accordance with IFRS 9 at FVPL (including on exercise of the fair value option[2]) that were not previously classified at FVPL in accordance with IAS 39.

Financial assets that relate to insurance activities

10. The staff interpret 'assets relating to insurance activities' as assets an entity holds (i) to fund the settlement of liabilities arising from expected levels of insurance claims and expenses; and (ii) additional (or surplus) assets an entity needs to hold in case insured events are more frequent, more severe, or require settlement sooner than expected. It is normal for insurers to hold surplus assets in the normal course of carrying out insurance activities, either to meet regulatory requirements or their own (internal) capital requirements.

11. Entities may hold a combination of financial assets relating to their insurance activities and financial assets relating to their non-insurance activities. IFRS does not define insurance activities, and the staff do not believe that such activities can be consistently defined across jurisdictions. Accordingly, the staff think that the IASB should instead seek to limit the application of the overlay adjustment to

[2] Permission afforded by paragraph 4.2.2 of IFRS 9 to designate financial assets as FVPL if doing so results in more relevant information (the fair value option)

financial assets relating to contracts within the scope of IFRS 4[3], which are defined in IFRS. Furthermore, it is the contracts within the scope of IFRS 4 that would be affected by the different effective dates of IFRS 9 and the new insurance contracts Standard.

12. In some cases it is easy to identify financial assets relating to particular contracts within the scope of IFRS 4, eg where those contracts reference specific financial assets, or where the entity holds ring fenced financial assets for particular portfolios of contracts that are within the scope of IFRS 4.

13. However there may also be situations in which the relationship between financial assets and contracts within the scope of IFRS 4 is unclear, for example when an entity holds general funds and uses those general funds to back and provide surplus assets for a variety of insurance and non-insurance contract liabilities.

14. If the IASB were to restrict the overlay adjustment to apply only for financial assets that are contractually linked to contracts within the scope of IFRS 4, then the scope of the overlay adjustment would be very narrow – it would be limited only to some types of participating contracts. However, the staff understand that the issues relating to accounting mismatches and other volatility in profit or loss arising from newly measuring assets at FVPL in accordance with IFRS 9 also relate to non-participating contracts.

15. Accordingly, the staff propose that entities should be allowed to designate financial assets relating to contracts within the scope of IFRS 4 and to disclose their policies for selecting such financial assets.

16. Thus, the staff propose that the entity would decide which financial assets relate to contracts within the scope of IFRS 4 and therefore to which assets the entity could apply the Overlay Approach. The staff further propose that entities would not be able to include assets clearly held in respect of activities other than contracts within the scope of IFRS 4, for example, financial assets of a group held by a banking subsidiary (that does not issue contracts within the scope of IFRS 4) or

[3] The staff notes that similar issues arise for investment contracts with discretionary participation features within the scope of IFRS 4 as well as for insurance contracts.

financial assets held in funds clearly ear-marked as relating to investment contracts that are outside of the scope of IFRS 4.

17. The staff considered but rejected *requiring* that entities apply the Overlay Approach to all financial assets that are eligible for the Overlay Approach. The staff consider that there may be eligible financial assets but, because of systems and processes issues that affect them, the entity might reasonably decide that the cost of applying the overlay adjustment outweighs any benefits in reducing volatility in profit or loss.

Changing designation of financial assets that relate to insurance activities by entities that apply the Overlay Approach

18. The staff propose that an entity that applies the Overlay Approach may only change the designation of financial assets to be within or outside the scope of the Overlay Approach if there is a change in the relationship between the financial assets and the contracts it issues that are within the scope of IFRS 4. The staff propose this condition for re-designation of financial assets to make use of the Overlay Approach by an entity more comparable over time by limiting an entity's ability to change a financial asset's designation. Redesignation of financial assets may be appropriate if there is a substantive change in the purpose for which assets are held, for example,

    (a) if most of an entity's contracts within the scope of IFRS 4 are transferred to another entity (in what is sometimes referred to as a portfolio transfer) financial assets retained by the entity that were previously designated as relating to contracts within the scope of IFRS 4 may be de-designated; and

    (b) if financial assets designated as relating to contracts within the scope of IFRS 4, and also designated as relating to an entity's insurance business for regulatory purposes (eg held within a 'long term business fund'), are transferred out of the regulatory insurance funds to be available to fund the entity's non-insurance expenses or dividends to shareholders, etc, the financial assets may be de-designated for the purposes of the Overlay Approach.

Additional temporary volatility in profit or loss

19. As discussed in the July meeting, the overlay adjustment is intended to target additional temporary volatility that arises in profit or loss when an entity applies IFRS 9 in conjunction with IFRS 4. In particular, the overlay adjustment is intended to target circumstances in which that additional temporary volatility arises from financial assets newly measured at FVPL in accordance with IFRS 9.

20. Financial assets newly measured at FVPL:

    (a) will give rise to a new (or additional) accounting mismatch if they back liabilities that are not remeasured to reflect changes in market discount rates (sometime referred to as liabilities measured on a cost or amortised cost basis).

    (b) will not give rise to an accounting mismatch if:

        (i) they represent surplus assets or

        (ii) they back liabilities measured to reflect current discount rates. Financial assets held to back current liabilities are generally measured at FVPL in accordance with IAS 39: either because of the nature of the financial asset or because the entity applies the IAS 39 fair value option.

21. However, the staff's experience is that it is often not feasible to specify whether assets back liabilities or represent surplus assets in anything other than an arbitrary way. Accordingly, the staff do not propose to require that the overlay adjustment should apply only when additional accounting mismatches arise.

22. The staff also do not propose to make transience of volatility an eligibility criterion for the Overlay Approach (ie exclude volatility that would continue under the new insurance contracts Standard from the overlay adjustment) as the IASB cannot expect an entity to know whether volatility is temporary without applying the new insurance contracts Standard, which is not yet complete. The IASB intends to allow preparers of financial statements at least three years from publication of the new Standard before requiring it to be applied.

23. For the reasons noted above, the staff do not think it is feasible for the IASB to restrict the scope of the Overlay Approach to financial assets that give rise to

additional accounting mismatches or temporary volatility in profit or loss. The staff note that minimising the number of criteria needed to apply the Overlay Approach makes it easier to understand and apply.

Question 1: Financial assets eligible for the overlay approach (eligible financial assets)
Does the Board agree that a reporting entity should be permitted to make an overlay adjustment in respect of financial assets that meet both of the following criteria: (a) the financial assets are designated by the entity as relating to contracts that are within the scope of IFRS 4; and (b) the financial assets are classified as FVPL in accordance with IFRS 9 and would not have been classified as FVPL in accordance with IAS 39? An entity may change the designation of financial assets as relating to contracts within the scope of IFRS 4 only if there is a change in the relationship between the financial assets and contracts that are within the scope of IFRS 4?

Redesignation of financial assets

24. A consequence of limiting the overlay adjustment to eligible financial assets is that the question arises what happens if, for an entity that applies the Overlay Approach:

    (a) financial assets previously acquired become eligible during the reporting period (for example an asset is transferred from a non-insurance business segment to an insurance business segment); or

    (b) financial assets previously eligible cease to be eligible during the reporting period (for example an asset is transferred from an insurance business segment to a non-insurance business segment).

25. In the staff's view, the overlay adjustment should be available to eligible financial assets, even if those assets were not previously eligible. The Overlay Approach should not be available when financial assets are no longer eligible. The staff

believe that such an approach would help meet the objective of permitting an overlay adjustment only for the targeted population of financial assets.

26. Accordingly, the staff propose that the overlay adjustment should be permitted for eligible financial assets from the time they first become eligible and should cease to apply when those financial assets are no longer eligible.

Applying the Overlay Approach when a financial asset becomes eligible

27. As stated in the previous paragraph, the overlay adjustment would apply when a financial asset first becomes eligible. Arguably, an entity could apply a cumulative catch up of the OCI amounts to create the balance that would have existed if the Overlay Approach had applied since initial recognition of the relevant financial assets. However, the staff do not propose this because:

    (a) the change in the assessment of the financial asset represents a circumstance that did not exist in the previous period, and

    (b) the objective of the overlay adjustment is to remove profit effects arising only for eligible financial assets.

    Accordingly, the staff propose that an entity applies the Overlay Approach prospectively to eligible financial assets (ie with no adjustment to the accumulated balance of OCI).

Accumulated balance of OCI when the Overlay Approach ceases

28. If an entity no longer applies the overlay adjustment to a financial asset, having previously done so, the question arises as to how any accumulated balance of OCI relating to the overlay adjustment would be recognised in profit or loss.

29. The staff expect accumulated OCI to self-reverse on derecognition of financial assets eligible for the Overlay Approach. However, the staff would expect there to be amounts in accumulated OCI when:

    (a) A financial asset is transferred away from the insurance business within a group or a change in its relationship with contracts within the scope of IFRS 4 causes the entity to de-designate a financial asset from the scope of the Overlay Approach

(b) The entity stops applying the Overlay Approach, either by choice or when the entity first applies the new insurance contracts Standard.

30. The treatment of accumulated OCI when an entity stops applying the Overlay Approach is discussed in paragraphs 44 and 45.

31. The staff have identified three alternative approaches on how to treat accumulated OCI when a financial asset ceases to be eligible for the Overlay Approach:

    (a) Recognise immediately in profit or loss (recycle)

    (b) Track the accumulated OCI balance and recycle to profit or loss when the financial assets are derecognised

    (c) Keep the balance within OCI indefinitely

32. Releasing amounts in accumulated OCI to profit or loss when financial assets are no longer eligible for the Overlay Approach has the benefit of simplicity. However, this is inconsistent with general practice in IFRS for internal transactions, the amounts released to profit or loss could be difficult to explain and this approach could provide some entities with opportunities to manage their reported profits.

33. Tracking amounts in accumulated OCI in respect of financial assets that leave the scope of the Overlay Adjustment and releasing those amounts to profit or loss when financial assets are derecognised by the entity is in keeping with normal accounting practice for the performance of financial assets measured on an amortised cost basis. However, such an approach could introduce significant operational complexity for preparers. Gains and losses in profit or loss on derecognition could also be difficult to explain.

34. Keeping balances within accumulated OCI indefinitely is simple but, in the staff's opinion, would not provide useful information.

35. To avoid operational complexity, and in the light of the temporary nature of the Overlay Approach, the staff propose that any accumulated balance of OCI relating to financial assets that cease to be eligible should be immediately transferred to profit or loss (recycled) when the financial asset no longer qualifies for the Overlay Approach.

36. Furthermore, to address any concerns about the potential for entities to make transfers or redesignate financial assets to achieve a particular accounting outcome, the staff propose that entities should be required to disclose an explanation of the amount of the total overlay adjustment in each period in a way that enables users of the financial statements to understand how it is derived. In particular the staff propose that entities should disclose the effect on profit or loss and OCI of transfers and redesignation of financial assets out of the scope of the Overlay Approach, including in respect of intra-group transfers and re-designation of financial assets.

Question 2: Newly applying or ceasing to apply the overlay adjustment
Does the Board agree that: (a) an entity applies the Overlay Approach prospectively to financial assets when the eligibility criteria are met; and (b) an entity ceases applying the Overlay Approach when financial assets no longer meet the eligibility criteria. Any accumulated balance of OCI relating to the overlay adjustment should be immediately reclassified to profit or loss (recycled).

Transition by entities to and from applying the Overlay Approach

37. Paragraphs 24 to 36 are concerned with applying the Overlay Approach to individual financial assets that enter or leave the scope of the Overlay Approach because they start or stop relating to contracts within the scope of IFRS 4. This section of the paper is concerned with transition to and from the Overlay Approach when:

    (a) An entity is first permitted to apply the Overlay Approach; and

    (b) An entity stops applying the Overlay Approach.

Initial application of the Overlay Approach by an entity

38. The Overlay Approach is designed to remove volatility in profit or loss that is created when entities apply IFRS 9 before the new insurance contracts Standard.

Thus, the application of IFRS 9 is a pre-condition for applying the Overlay Approach and the Overlay Approach can only be applied when an entity simultaneously applies IFRS 9. The staff propose that an entity would be permitted to apply the Overlay Approach before the mandatory effective date of IFRS 9 if it chooses to apply IFRS 9 early.

39. The staff notes that the Overlay Approach is intended to provide relief from additional temporary volatility when assets that were not previously measured (or would not have been measured) at FVPL are measured at FVPL in accordance with IFRS 9. Therefore, the staff propose that an entity should be permitted to start to apply the Overlay Approach only when it first applies IFRS 9. An entity that has already applied IFRS 9 without applying the Overlay Approach would not be allowed to start applying the Overlay Approach subsequently.

40. The staff propose that an entity should apply the Overlay Approach retrospectively to eligible financial assets, ie, restate opening balances for assets and accumulated OCI. The entity should recognise as an adjustment to the opening balance of OCI an amount equal to the difference between the fair value of the financial asset and its amortised cost or cost carrying amount determined in accordance with IAS 39 immediately prior to transition to IFRS 9.

41. The opening adjustments to accumulated OCI that the staff propose mirror the transition journals that are required by IFRS 9. Entities are required to apply IFRS 9 retrospectively, ie, on transition to IFRS 9 financial assets and liabilities are treated as if they had always been measured in accordance with IFRS 9

42. In paragraph 27, staff propose that an entity applies the Overlay Approach prospectively to financial assets which have only become eligible after purchase (ie with no adjustment to the accumulated balance of OCI). To be consistent with this principle, entities would be required to identify eligible financial assets on transition that had been purchased before they related to insurance activities, eg if financial assets were transferred within a group prior to transition. Unrealised gains and losses at transition that arose before the asset became eligible should not form part of the opening adjustment to accumulated OCI. However, the staff are not proposing this treatment because of the cost and complexity that it would involve.

43. In order to make comparatives comparable with the current reporting period, the staff propose that when an entity first applies the Overlay Approach to its financial assets, the entity would be required to apply the Overlay Approach to the comparative information if the entity restates that comparative information under IFRS 9. However, an entity is permitted not to restate comparatives under IFRS 9 (and, in some cases, is prohibited from restating comparatives). In such cases, the staff propose that the entity should not be permitted to apply the Overlay Approach to the comparative information[4].

Ceasing to apply the Overlay Approach

44. The rationale for permitting an Overlay Approach would no longer exist when an entity applies the new insurance contracts Standard. Consequently, the staff propose that an entity should be required to stop applying the Overlay Approach when it applies the new insurance contracts Standard. The 2013 ED proposed that on transition to the new insurance contracts Standard, any transition adjustments would result in an adjustment to the opening balance of retained earnings in the earliest reporting period presented. Therefore, when an entity stops applying the Overlay Approach because of transition to the new insurance contracts Standard, the staff propose that the entity should reclassify any balance of the prior periods' overlay adjustments accumulated in OCI to retained earnings as of the beginning of the earliest reporting period presented.

45. The staff propose that entities should be permitted to stop applying the Overlay Approach before the application of the new insurance contracts Standard. Although this would reduce period to period comparability for a reporting entity, permitting an entity to stop applying the Overlay Approach would allow an entity to make a cost-benefit assessment of applying the Overlay Approach in its individual circumstances. For example, an entity might decide to stop applying the Overlay Approach if it were to stop holding significant amounts of eligible financial assets. The staff propose that the entity should reclassify any balance of the prior periods' overlay adjustments accumulated in OCI to retained earnings as

[4] It is necessary to adjust opening balances relating to financial instruments on transition to IFRS 9 if comparatives are not restated. Such opening adjustment would also need to reflect opening overlay adjustments when comparatives are not restated.

of the beginning of the earliest reporting period presented. This would mean that an entity would provide restated comparative information, which could help address concerns about comparability.

Question 3: Transition by entities to and from the Overlay Approach

Does the Board agree that:

(a) An entity should be permitted to apply the Overlay Approach only when it first applies IFRS 9, including if it chooses to apply IFRS 9 early;

(b) an entity should apply the Overlay Approach retrospectively to eligible financial assets on transition to IFRS 9. The entity should recognise as an adjustment to the opening balance of OCI an amount equal to the difference between the fair value of financial assets and their amortised cost or cost carrying amount determined in accordance with IAS 39 immediately prior to transition to IFRS 9;

(c) an entity should restate comparative information to reflect the Overlay Approach only if the entity also restates that comparative information in accordance with IFRS 9;

(d) an entity should stop applying the Overlay Approach when it applies the new insurance contracts Standard and should be permitted to stop applying the Overlay Approach in any reporting period; and

(e) when an entity stops applying the Overlay Approach it should reclassify any balance of the prior periods' overlay adjustments accumulated in OCI to retained earnings as of the beginning of the earliest reporting period presented?

Presentation of the overlay adjustment in the statement of comprehensive income

46. One of the main benefits of the overlay approach is that IFRS 9 information will be available in the statements of financial position and comprehensive income. This would provide users of financial statements with information that could be used to compare IFRS reporters. In order to achieve that outcome, an entity will need to clearly show the effect of the overlay adjustment on profit or loss and OCI in each period.

47. The overlay adjustment moves an amount of gain or loss from profit or loss to OCI. Presentation of the amount of the total overlay adjustment in each period would allow users to calculate what profit before tax would have been without the overlay adjustment and consequently to compare profit or loss on a consistent basis between entities that do or do not apply the Overlay Approach.

48. Because the amount of the Overlay Approach in profit or loss is equal and opposite to the adjustment in OCI, the staff propose to require that an entity present at least that single line item in profit or loss or OCI. This would ensure that the total adjustment to profit or loss would be clearly visible on the face of the statement of comprehensive income (albeit sometimes in OCI).

49. One consequence of this approach is that an entity would have flexibility about how to present the effect of the overlay adjustment in the statement of profit or loss.

50. The staff considered requiring explanation of the effect of the overlay adjustment in profit or loss, either as a single line item in profit or loss, or on relevant line items on the face of the profit or loss section of the statement of comprehensive income. However, the staff note that the general principle in IAS 1 is to permit entities to determine the presentation that is most relevant to an understanding of the entity's financial performance. Requiring particular line items, such as an IFRS 9 subtotal would restrict the presentation formats that would be available. Similarly, requiring explanation of the effect of the overlay adjustment on each relevant line item on the face of the profit or loss would restrict an entity from making a judgement as to whether presentation on the face of the statement of profit or loss would be useful. Accordingly, the staff propose that there should not be a requirement for an entity to present the overlay adjustment as a single line item in profit or loss, or to explain the effect of the overlay adjustment on relevant line items on the face of the profit or loss section of the statement of comprehensive income. Similarly, the staff do not propose to prohibit entities from presenting additional line items, headings and sub totals in the statement of comprehensive income.

51. However, the staff propose that to ensure information about IFRS 9 is readily available to users of financial statements, the effect of the overlay adjustment on

line items in profit or loss should be disclosed in the notes to the financial statements, if it is not separately identified on the face of the profit or loss account.

Question 4: Presentation of the overlay adjustment in the statement of comprehensive income
Does the Board agree that: An entity that applies the Overlay Approach should present a single line item for the amount of the overlay adjustment in the profit or loss or the other comprehensive income section of the statement of comprehensive income or both?

Disclosures required when the overlay adjustment is applied

52. The staff note that, if the Board agrees with the staff recommendations in this paper, the Overlay Approach would be optional. Not all entities that issue insurance contracts and apply IFRS 9 will apply the Overlay Approach, and an entity that applies the Overlay Approach may not apply it to all its financial assets. Accordingly, the staff propose that entities disclose the information that makes users of financial statement aware that the Overlay Approach has been applied, ie the fact that the entity has made an overlay adjustment, and to which financial assets. Such disclosures would help users to understand the context of the adjustments and specifics about the amount of adjustment in each period.

53. In addition, the staff propose the following disclosures:

    (a) entities should disclose their policies for designating financial assets that relate to contracts within the scope of IFRS 4

    (b) an explanation of the amount of the total overlay adjustment in each period in a way that enables users of the financial statements to understand how it is derived. In particular the staff propose that entities should disclose the effect on profit or loss and OCI of transfers and redesignation of financial assets out of the scope of the Overlay Approach, as follows:

(i) The amount of overlay adjustment in profit or loss and OCI relating to financial assets newly within the scope of the Overlay Approach;

(ii) The amount of overlay adjustment that would have arisen in profit or loss and OCI in a period if financial assets had not been removed from the scope of the Overlay Approach;

(iii) The amount of overlay adjustment due to reclassification of amounts in accumulated OCI to profit of loss in respect of financial assets removed from the scope of the Overlay Approach; and

(c) the effect of the overlay adjustment on line items in profit or loss should be disclosed in the notes to the financial statements, if it is not separately identified on the face of the profit or loss account.

Question 5: Disclosures

Does the Board agree that entities that apply the Overlay Approach should disclose in each period:

(a) the fact that the entity has made an overlay adjustment, and the financial assets to which the overlay adjustment relates;

(b) the entity's policy for determining the financial assets for which an overlay adjustment is made;

(c) an explanation of the amount of the total overlay adjustment in each period in a way that enables users of the financial statements to understand how it is derived. In particular, an entity should disclose the following in respect of intra-group transfers and re-designation of financial assets:

(i) The amount of overlay adjustment in profit or loss and OCI relating to financial assets newly within the scope of the Overlay Approach;

(ii) The amount of overlay adjustment that would have arisen in profit or loss and OCI in a period if financial assets had not been removed from the scope of the Overlay Approach; and

(iii) The amount of overlay adjustment due to reclassification of amounts in accumulated OCI to profit or loss in respect of financial assets removed from the scope of the Overlay Approach; and

(d) the effect of the overlay adjustment on line items in profit or loss should be disclosed in the notes to the financial statements, if it is not separately identified on the face of the profit or loss account?

Operational implications of the Overlay Approach

54. The overlay adjustment compares the profit determined on the basis of IFRS 9 and on the basis of IAS 39 for financial assets within the scope of the overlay adjustment. Because the Overlay Approach can be initially applied when it first applies IFRS 9 the entity would:

    (a) Have applied IAS 39 in the previous accounting period; and

    (b) Be applying IFRS 9 in the current accounting period.

55. Accordingly, the staff have considered the operational implications of the Overlay Approach compared to applying IAS 39 and to IFRS 9.

56. The staff do not expect there to be a significant incremental cost to making an overlay adjustment compared to applying IAS 39. This is because the overlay adjustment applies only to financial assets that are measured at FVPL in accordance with IFRS 9 that were not measured (or would not be measured) at FVPL in accordance with IAS 39. Accordingly there is no incremental information needed to apply IFRS 9 because IAS 39 already requires that entities disclose the fair value of financial assets not measured at fair value. Thus, the information needed to measure such assets at FVPL in accordance with IFRS, ie the fair value of the financial assets at the beginning and end of each reporting period, should be available under the entity's existing accounting systems. The incremental cost that would arise in determining the overlay adjustment would be in the designation and tracking of the financial assets to which the Overlay Approach is applied.

57. The staff acknowledge that there is an increased cost in applying the overlay adjustment compared to applying only IFRS 9. This is because the amortised cost

and ‘incurred loss’ impairment information is needed for profit or loss to measure the financial assets in accordance with IAS 39. Also, it may be necessary to calculate shadow accounting adjustments with and without the effect of reclassifying financial assets to FVPL. However:

(a) The overlay adjustment is optional, so if the cost of continuing to apply IAS 39 to financial assets relating to a portfolio of insurance contracts is excessive, then an entity could choose not to apply it but instead explain the additional volatility to its investors;

(b) The overlay adjustment would only apply if the entity was already measuring the financial assets at something other than FVPL under IAS 39, consequently the entity will already have that system in place.

Appendix A: the interaction of the Overlay Approach with shadow accounting

A1. The appendix to Agenda paper 14C discusses how the overlay adjustment is determined. In particular:

a. Paragraphs A2 - A4 provides a worked example of how an entity would determine the overlay adjustment; and

b. Paragraphs A5 - A12 describe how the overlay adjustment would be determined when an entity applies shadow accounting in accordance with IFRS 4.

Worked example of the Overlay Approach

A2. The following example illustrates how an entity would determine the overlay adjustment for a zero coupon convertible corporate bond. In accordance with IAS 39, the conversion option embedded in the financial instrument is separated and measured at FVPL. The host contract is measured at amortised cost. The entire bond is accounted for at FVPL in accordance with IFRS 9. For example, assume that:

a. An entity purchases a zero coupon corporate bond at the beginning of Year 1 for CU500.

b. The bond includes a right for the holders of the bond to convert their holdings to a fixed number of the equity shares of the company that issued the bond at the end of Year 10.

c. At the start of Year 1 the fair value of the conversion option is CU12. At the end of Year 1 the fair value of the conversion option is CU3 [fair value loss of CU9].

d. At the start of Year 1 the separated host contract measured at amortised cost is CU488. At the end of Year 1 the carrying value of the amortised cost host contract is CU422.

e. The incurred loss for the year for the host element of the bond, in accordance with IAS 39, would have been CU88.

f. Interest income in Year 1 at the effective interest rate on the host portion of the bond is CU22

g. The fair value of the whole bond (not separated into components) at the end of Year 1 is CU440 [fair value loss of CU60]

A3. Accounting for the bond in Year 1 in accordance with IFRS 9 and IAS 39 is as follows:

CU	IFRS 9	IAS 39
Beginning of Year 1	500	500
Fair value loss in Year 1	(60)	(9)
Interest income		22
Impairment		(88)
Total	(60)	(75)
Carrying value of bond (IFRS 9) and the sum of the carrying value of the host contract and fair value of the embedded derivative (IAS 39) at end of Year 1	440	425

A4. If the bond was subject to the overlay adjustment, the entity would recognise an overlay adjustment in profit of loss of minus CU15 [CU(75) – CU(60)]. The statement of comprehensive income in Year 1 would be as follows:

	CU
Profit and loss	
Fair value loss in accordance with IFRS 9	(60)
Overlay adjustment	(15)
Other comprehensive income	
Overlay adjustment	15
Total comprehensive income	(60)

Making an overlay adjustment when an entity applies shadow accounting

A5. The application of the Overlay Approach needs to consider a potential interaction with shadow accounting.

A6. Paragraph 30 of IFRS 4 permits the use of a form of shadow accounting as follows:

> In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of (a) its insurance liabilities, (b) related deferred acquisition costs and (c) related intangible assets, such as those described in paragraphs 31 and 32[5]. An insurer is permitted, but not required, to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in other comprehensive income if, and only if, the unrealised gains or losses are recognised in other comprehensive income. This practice is sometimes described as 'shadow accounting'.

[5] Paragraphs 31 and 32 of IFRS 4 refer to an expanded presentation that splits the fair value of insurance contracts acquired in a business combination or portfolio transfer into (a) a liability measured in accordance with the insurer's accounting policies and; (b) an intangible asset representing the difference between the fair value of the contracts acquired and (a).

A7. Shadow accounting enables entities to adjust aggregate insurance liabilities to reduce accounting mismatches that can arise when unrealised gains and losses on assets held by the entity are recognised in the financial statements (in profit or loss or OCI) but corresponding changes in the measurement of the insurance contract liabilities are not. The Overlay Approach also reduces accounting mismatches although it targets the effect of newly measured at FVPL assets on profit or loss. There is a potential overlap in respect of financial assets within the scope of both approaches.

A8. Shadow accounting is a well-established practice used by many insurers that apply IFRS 4 whereas the Overlay Approach is designed to be a temporary solution to an issue that arises in the transition period between the application of IFRS 9 and the new insurance contracts Standard. As a consequence entities that apply shadow accounting should continue to do so in accordance with their accounting policies. The overlay adjustment is available to remove from profit or loss the effect on profit or loss of assets newly measured at FVPL *after* applying shadow accounting

Illustrative example of the interaction of the Overlay Approach with shadow accounting

A9. The staff illustrate the interaction of shadow accounting and the Overlay Approach with an example in which an entity that applies shadow accounting holds a combination of derivatives and equity instruments that underlie contracts within the scope of shadow accounting. Prior to applying IFRS 9 the entity classifies the derivatives at FVPL and the equities at AFS in accordance with IAS 39. The entity classifies the derivatives and equities as FVPL in accordance with IFRS 9.

A10. Assumptions

a. Policyholders have a right to receive 90% of income and realised gains from a specified pool of financial assets

b. Contract would be eligible for the variable fee approach

c. The derivatives experience a fair value gain of CU20 and equities CU80 in a period

d. Ignore tax

IAS 39

Unrealised gains on FVPL and AFS financial *assets - before shadow accounting*

Dr financial assets	100	
Cr P&L – unrealised gain on FVPL derivatives		20
Cr OCI – unrealised gains on AFS equities		80

Shadow accounting adjustment

Dr P&L – unrealised gains	18	
Dr OCI – unrealised gains	72	
Cr Deferred policyholder liability		90

Net effect of unrealised gains and shadow accounting adjustment

Dr Financial assets	100	
Cr Deferred policyholder liability		90
Cr P&L – unrealised gains		2
Cr OCI – unrealised gains		8

IFRS 9		
Unrealised gain on FVPL financial assets – before adjustments		
Dr Financial assets	100	
Cr P&L – unrealised gains		100
Shadow accounting adjustment		
Dr P&L – unrealised gains	90	
Cr Deferred policyholder liability		90
Net effect of unrealised gain and shadow accounting adjustment		
Dr Assets	100	
Cr Deferred policyholder liability		90
Cr P&L – unrealised gains		10
Overlay adjustment after shadow accounting adjustment		
Dr P&L - overlay	8	
Cr OCI - overlay		8
Summary of net effect of unrealised gain, shadow accounting and overlay adjustment		
Dr Assets	100	
Cr Deferred policyholder liability		90
Cr P&L – net of unrealised gains and overlay		2
Cr OCI - overlay		8

A11. The overlay adjustment in this example removes from profit or loss an amount equal to the difference between profit in accordance with IAS 39 and the effect of reclassifying financial assets to FVPL *after* applying shadow accounting.

A12. To be consistent with the staff recommendation in paragraph 40, regarding retrospective application of the Overlay Approach on initial application, an entity that applies shadow accounting would need to reinstate amounts in

accumulated OCI relating to shadow accounting adjustment at the date of transition to IFRS 9 and the Overlay Approach.

Appendix B: Illustrative examples of the Overlay Approach in a range of scenarios

B1. The staff have prepared the following tables to illustrate overlay adjustments in a range of scenarios. The purpose of the tables is to show how the overlay adjustment is derived in different combinations of circumstances in which financial assets enter and exit the scope of the Overlay Approach. The table demonstrate how an accumulated balance in OCI may arise when a financial asset stops being subject to the Overlay Approach and shows the staff proposals in this paper on how to clear such balances.

B2. Financial assets may become subject to the Overlay Approach because they are newly measured FVPL financial assets that are designated as relating to contracts within the scope of IFRS 4 on initial application of the Overlay Approach (initial application of the Overlay Approach is only permitted on transition to IFRS 9); or subsequently recognised by the entity and designated as relating to contracts within the scope of IFRS 4; or subsequently transferred within an entity or otherwise designated as relating to contracts within the scope of IFRS 4.

B3. Financial assets previously within the scope of the Overlay Approach may stop being subject to the Overlay Approach on derecognition; transfer or dedesignation or when an entity stops applying the Overlay Approach to its financial assets – either voluntarily or mandatorily when the new insurance contracts Standard is applied.

B4. The table shows, inter alia, expected amounts in profit or loss for IFRS 9 fair value movements during the financial assets time within the scope of the Overlay Approach and overlay adjustments to make profit equal to what it would have been in accordance with IAS 39. The logic is supplemented with numbers for six illustrative scenarios.

No	Start	Finish	IFRS 9 P&L to Finish	IAS 39 P&L to Finish	Overlay P&L to Finish	Accumulated OCI (AOCI) at Start	AOCI at Finish	How to clear AOCI at Finish
1	IFRS 9 transition	Derecognition	$FV_{Derec} - FV_{Trans}$	$FV_{Derec} - AC_{Trans}$	$FV_{Trans} - AC_{Trans}$	$FV_{Trans} - AC_{Trans}$	Nil	N/A
			100-80=20Cr [100 FV @ derecognition 80 FV on transition]	100-65=35Cr [65 AC @ transition]	35-20=15Cr PL 80-65=15Cr PL 15Dr to OCI	80-65=15Cr OCI	15Cr + 15Dr = Nil	
2		Tfr/dedesignation out of scope	$FV_{Tfr\ Out} - FV_{Trans}$	$AC_{Tfr\ Out} - AC_{Trans}$	$AC_{Tfr\ Out} - AC_{Trans} - FV_{Tfr\ Out} + FV_{Trans}$	$FV_{Trans} - AC_{Trans}$	$FV_{Tfr\ Out} - AC_{Tfr\ Out}$	Release to P&L immediately
			90-80=10Cr [90 FV @ Tfr out]	87-65=22Cr [87 AC @ Tfr out]	22-10=12Cr PL 87-65-90+80 =12Cr PL 12Dr to OCI	80-65=15Cr OCI	15Cr + 12Dr = 3Cr 90-87=3	
3		Stop Overlay - voluntary	$FV_{StopV} - FV_{Trans}$	$AC_{StopV} - AC_{Trans}$	$AC_{StopV} - AC_{Trans} - FV_{StopV} + FV_{Trans}$	$FV_{Trans} - AC_{Trans}$	$FV_{StopV} - AC_{StopV}$	Tfr to retained profit b/f at earliest period presented
			92-80=12Cr [92 FV @ start of period]	89-65=24Cr [89 AC @ stop]	24-12=12Cr PL 89-65-92+80 =12Cr PL 12Dr to OCI	80-65=15Cr OCI	15Cr + 12Dr = 3Cr 92-89 = 3	
4		Stop Overlay - new Std (mandatory)	$FV_{StopM} - FV_{Trans}$	$AC_{StopM} - AC_{Trans}$	$AC_{StopM} - AC_{Trans} - FV_{StopM} + FV_{Trans}$	$FV_{Trans} - AC_{Trans}$	$FV_{StopM} - AC_{StopM}$	Tfr to retained profit b/f at earliest period presented
			Numerical example as for voluntary cessation of Overlay Approach					

No	Start	Finish	IFRS 9 P&L to Finish	IAS 39 P&L to Finish	Overlay P&L to Finish	Accumulated OCI (AOCI) at Start	AOCI at Finish	How to clear AOCI at Finish
5	Recognition post IFRS 9 transition	Derecognition	FV_{Derec} - FV_{Rec}	FV_{Derec} - FV_{Rec} [FV_{Rec}=AC_{Rec}]	Nil	Nil	Nil	N/A
			100 – 82 = 18 FV = 82 @ Recognition	100 – 82 = 18	18 – 18 = 0	Nil	Nil	
6		Tfr/dedesignation out of scope	$FV_{Tfr\ Out}$ – FV_{Rec}	$AC_{Tfr\ Out}$ – FV_{Rec}	$AC_{Tfr\ Out}$ - $FV_{Tfr\ Out}$	Nil	$FV_{Tfr\ Out}$ - $AC_{Tfr\ Out}$	Release to P&L immediately
			91 – 82 = 9 FV = 91 @ Tfr	89 – 82 = 7 AC = 89 @ Tfr	7 – 9 = -2 Dr PL 89 – 91 = -2 2 Cr to OCI	Nil	2 Cr 91-89 = 2	
7		Stop overlay - voluntary	FV_{StopV} - FV_{Rec}	AC_{StopV} – FV_{Rec}	AC_{StopV} – FV_{StopV}	Nil	FV_{StopV} - AC_{StopV}	Tfr to retained profit b/f at earliest period presented
			95 – 82 = 13 FV @ start of end period = 95	90 – 82 = 8 AC @ start of end period = 90	8 – 13 = -5 Dr PL 90 – 95 = -5 5 Cr to OCI	Nil	5 Cr 95-90=5	
8		Stop - new Std (mandatory)	FV_{StopM} - FV_{Rec}	AC_{StopM} – FV_{Rec}	AC_{StopM} – FV_{StopM}	Nil	FV_{StopM} - AC_{StopM}	Tfr to retained profit b/f at earliest period presented
			Numerical example as for voluntary cessation of Overlay Approach					

No	Start	Finish	IFRS 9 P&L to Finish	IAS 39 P&L to Finish	Overlay P&L to Finish	Accumulated OCI (AOCI) at Start	AOCI at Finish	How to clear AOCI at Finish
9	Tfr/designation into scope post IFRS 9 transition	Derecognition	$FV_{Derec} – FV_{Tfr\ In}$	$FV_{Derec} – FV_{Tfr\ In}$ [$FV_{Tfr\ In}=AC_{Tfr\ In}$]	Nil	Nil	Nil	N/A
10		Tfr/dedesignation out of scope	$FV_{Tfr\ Out} – FV_{Tfr\ In}$	$AC_{Tfr\ Out} – FV_{Tfr\ In}$	$AC_{Tfr\ Out} - FV_{Tfr\ Out}$	Nil	$FV_{Tfr\ Out} - AC_{Tfr\ Out}$	Release to P&L immediately
11		Stop overlay - voluntary	$FV_{StopV} – FV_{Tfr\ In}$	$AC_{StopV} – FV_{Tfr\ In}$	$AC_{StopV} – FV_{StopV}$	Nil	$FV_{StopV} - AC_{StopV}$	Tfr to retained profit b/f at earliest period presented
12		Stop - new Std (mandatory)	$FV_{StopM} – FV_{Tfr\ In}$	$AC_{StopM} – FV_{Tfr\ In}$	$AC_{StopM} – FV_{StopM}$	Nil	$FV_{StopM} - AC_{StopM}$	Tfr to retained profit b/f at earliest period presented

Abbreviations:

FV = fair value

AC = amortised cost