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STAFF PAPER

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Project	**Amendments to IFRS 4: Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts***		
Paper topic	The overlay approach		

CONTACT(S)	Izabela Ruta	iruta@ifrs.org	+44 (0)20 7246 6957
	Conor Geraghty	cgeraghty@ifrs.org	+44 (0)20 7246 0553

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Purpose of this paper

1. This paper discusses the feedback received on the overlay approach in comment letters and other outreach and considers whether any aspect of the overlay approach as proposed in the ED should be amended.

2. The overlay approach permits an entity to reclassify between profit or loss (P&L) and other comprehensive income (OCI) the difference between the amounts reported in P&L for qualifying assets applying IFRS 9 and IAS 39 (overlay adjustment) [Paragraph 35A of the ED]. At its March 2016 meeting, the Board decided to confirm the ED proposal to provide an overlay approach and that the overlay approach should be optional.

3. The staff are asking the Board to confirm some aspects and change some aspects of the overlay approach that received significant attention in comment letters and other feedback relating to:

   (a) Qualifying assets for the overlay approach, and related disclosures (discussed in paragraphs 11-27);

   (b) The presentation of the overlay approach (discussed in paragraphs 28 - 37).

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4. The staff are also asking the Board to confirm other aspects of the overlay approach that were uncontroversial or widely supported by stakeholders (in paragraphs 38- 44).

5. This paper does not address the remaining issues relating to the overlay approach that are outlined in Agenda paper 14 *Cover note*. Those issues, including whether there should be a fixed expiry date for the overlay approach, will be discussed in May 2016. Also, the paper does not address drafting suggestions relating to the overlay approach. Those suggestions will be considered when drafting the amendments.

Staff recommendations

Qualifying assets for the overlay approach and related disclosures

6. The staff recommend that the Board **confirms the ED proposals** relating to the qualifying assets as follows:

   (a) A financial asset qualifies for the overlay approach if it is designated as relating to contracts that are within the scope of IFRS 4 and it is measured at fair value through profit or loss (FVPL) applying IFRS 9 but would not have been measured at FVPL in its entirety applying IAS 39. [paragraph 35B of the ED]

   (b) An entity that applies the overlay approach:

      (i) may newly designate a previously recognised financial asset as relating to contracts within the scope of IFRS 4 if, and only if, there is a change in the relationship between that financial asset and the contracts within the scope of IFRS 4. At the date of designation, the fair value of a financial asset newly designated as relating to contracts within the scope of IFRS 4 shall be its new amortised cost carrying amount. The effective interest rate for such a financial asset is determined based on its fair value at the date of designation.

      (ii) shall de-designate a previously recognised financial asset as relating to contracts within the scope of IFRS 4 only when

there is a change in the relationship between that financial asset and the contracts within the scope of IFRS 4.

(iii) shall reclassify to P&L any balance accumulated in OCI relating to a previously designated financial asset if and when that financial asset no longer meets the qualifying criteria above in sub-paragraph 6(a)
[paragraph 35E (a)-(c) of the ED]

(c) An entity that applies the overlay approach is required to disclose sufficient information to enable users of financial statements to understand how the amount of the overlay adjustment is calculated and the effect of the adjustment on the financial statements. In order to achieve this objective, an entity is required to disclose:

(i) the fact that the entity has applied the overlay approach in the reporting period and the carrying amount and classes of financial assets to which the reclassified amount relates;

(ii) the entity's basis for determining assets to which the overlay approach is applied; and

(iii) an explanation of the amount of the overlay adjustment and the effect on the financial statements of changes in designation of financial assets during the reporting period.

[paragraphs 37C and 37D (a) – (d) of the ED].

7. The staff also recommend that the Board:

(a) clarify that qualifying financial assets could include surplus financial assets that an entity holds for the purposes of regulatory, credit rating or internal capital requirements. Consequently surplus financial assets may be designated as relating to contracts within the scope of IFRS 4, as described in paragraph 35B of the ED;

(b) require that an entity explain, consistent with paragraph 37D(b) of the ED, the basis for designating financial assets held by one legal entity as relating to contracts within the scope of IFRS 4 that are issued by a different legal entity within the same group.

Presentation of the overlay approach

8. The staff recommend that the Board **amends the ED proposals** in paragraph 35C and 37D(e) relating to the presentation of gains and losses for financial assets to which the overlay approach is applied, to require:

   (a) An entity to present:

      (i) in P&L, information that reflects the application of IFRS 9, with a single, separate line item for the overlay adjustment; and

      (ii) in OCI, the overlay adjustment separately from other components of OCI consistently with IAS 1 *Presentation of Financial Statements*; and

   (b) An entity to disclose the effect of the overlay approach on individual line items in the notes to the financial statements.

Other aspects of the overlay approach

9. The staff recommend that the Board confirms the ED proposals relating to:

   (a) initially applying, and ceasing to apply, the overlay approach [paragraphs 35D, 35E(d), and 35F of the ED];

   (b) applying the overlay adjustment to pre-tax profit or loss [paragraph BC24 of the ED]; and

   (c) transition to the overlay approach [paragraph 41K of the ED].

Structure of this paper

10. This paper discusses:

   (a) Qualifying financial assets for the overlay approach, and related disclosures

      (i) ED proposals on qualifying financial assets, changes in designation of financial assets and related disclosures (paragraphs 11 - 13)

(ii) Summary of feedback received in comment letters and other outreach (paragraphs 14 - 16)

(iii) Staff analysis and recommendations (paragraphs 17 - 27)

(b) Presentation of the overlay adjustment

(i) ED proposals on the presentation of the overlay adjustment and related disclosures (paragraph 28)

(ii) Summary of feedback received in comment letters and other outreach (paragraphs 29 - 30)

(iii) Staff analysis and recommendations (paragraphs 31 - 37)

(c) Other aspects of the overlay approach (paragraphs 38 - 44)

(i) Initial application of, or ceasing to apply, the overlay approach (paragraphs 39 - 41)

(ii) applying the overlay adjustment to pre-tax profit or loss (paragraphs 42 - 43);

(iii) Transition to the overlay approach (paragraph 44)

Qualifying financial assets for the overlay approach and related disclosures

ED proposals

Qualifying financial assets

11. The ED proposed that a financial asset qualifies for the overlay approach if it is designated as relating to contracts that are within the scope of IFRS 4 and it is measured at FVPL applying IFRS 9 but would not have been measured at FVPL in its entirety applying IAS 39 [paragraph 35B of the ED]. The Board noted, in the Basis for Conclusions on the ED (paragraph BC 38), that entities would not be able to designate financial assets that are held in respect of activities other than those associated with contracts within the scope of IFRS 4 (eg, financial assets backing banking activities). However, the Board acknowledged, in paragraph BC39 of the

ED, that different entities could use different approaches to designating financial assets as relating to contracts that are within the scope of IFRS 4.

12. The ED prescribes the circumstances in which an entity can newly designate or de-designate a previously recognised financial asset and the mechanics for how such changes in designation are applied [Paragraph 35E (a) – (c) of the ED], as follows:

    (a) An entity may ***newly designate*** a previously recognised financial asset as relating to contracts within the scope of this IFRS if there is a change in the relationship between that financial asset and the contracts within the scope of IFRS 4. At the date of designation, the fair value of a financial asset newly designated as relating to contracts within the scope of IFRS 4 shall be its new amortised cost carrying amount. The effective interest rate for such a financial asset is determined based on its fair value at the date of designation.

    (b) An entity is required to ***de-designate*** a previously recognised financial asset as relating to contracts within the scope of IFRS 4 only when there is a change in the relationship between that financial asset and the contracts within the scope of IFRS 4.

    (c) When the entity de-designates such a financial asset, the entity shall reclassify to P&L any balance accumulated in OCI relating to that previously designated financial asset.

Disclosures

13. The ED proposed that if an entity applies the overlay approach it should disclose sufficient information to enable users of financial statements to understand how the amount reclassified in the reporting period is calculated and the effect of that reclassification on the financial statements [Paragraph 37C of the ED]. Paragraph 37D (a) to (d) of the ED lists the following disclosures that are necessary to meet that general objective:

(a) The fact that it has applied the overlay approach in the reporting period and the carrying amount and classes of financial assets to which the reclassified amount relates.

(b) Its basis for determining the financial assets to which the overlay approach is applied.

(c) An explanation of the total amount reclassified from P&L to OCI in the reporting period in a way that enables users of financial statements to understand how it is derived.

(d) If, during the reporting period, the entity has changed the designation of financial assets:

  (i) the amount reclassified from P&L to OCI in the reporting period relating to financial assets newly within the scope of the overlay approach;

  (ii) the amount that would have been reclassified from P&L to OCI in the reporting period if those financial assets had not been removed from the scope of the overlay approach; and

  (iii) the amount reported in P&L in the reporting period arising from reclassifying any balance accumulated in OCI in respect of financial assets that have been de-designated.

Feedback received in comment letters and other outreach

14. Most agreed with the ED proposals on the qualifying assets. However, a few respondents to the ED, including regulators and audit firms, were concerned about the risk of inconsistent application of the overlay approach, both between different entities and within a single entity over time. Some of these respondents asked the Board to amend that criterion to specify more precisely the assets that could be designated; or to restrict application of the overlay approach to only those assets held in the same legal entity that issued the contracts within the scope of IFRS 4. Additionally, some expressed concerns that the proposals relating to the designation

of qualifying financial assets and changes in those designations could create opportunities for earnings management.

15. In contrast, some standard setters, preparers and audit firms welcomed the ED proposals that entities would be permitted to designate the financial assets for the overlay approach and did not think further restriction was appropriate. They emphasised the fact that entities choosing to apply the overlay approach may have operations that are under different regulatory and GAAP regimes, and noted that the ED proposals would accommodate a range of entities and their differing circumstances.

16. Some asked the Board to clarify the criterion 'relating to contracts that are within the scope of IFRS 4' [in paragraph 35B(a) of the ED]. In particular, some asked whether surplus funds or capital assets could be designated as relating to contracts within the scope of IFRS 4.

Staff analysis and recommendations

Inconsistent designation of financial assets relating to contracts within the scope of IFRS 4

17. As noted in paragraph 11, the Board acknowledged that different entities could use different approaches to designating financial assets as relating to contracts that are within the scope of IFRS 4. However, the Board noted two mitigating factors:

    (a) that entities will apply IFRS 9 to the designated financial assets (consistently with financial assets that that are not subject to the overlay approach); and

    (b) that the proposed presentation and disclosure requirements (eg, in paragraphs 37C and 37D of the ED) will make the calculation and effect of the overlay approach transparent – for example, an entity must disclose the basis for determining the financial assets to which the overlay is applied and information about any changes in the designation during the reporting period.

18. In addition, the staff note that the requirements in paragraphs 35E (a) and (b), that an entity may only change the designation of a previously recognised financial asset if there is a change in the relationship between the financial assets and contracts within the scope of IFRS 4, further restricts an entity's ability to make such changes in order to achieve a desired effect on profit or loss.

19. The staff think it is necessary to weigh the benefits of providing more guidance on how entities should identify financial assets that relate to contracts within the scope of IFRS 4 (ie to address the concerns described in paragraph 14) against the risk that this could impose unintended and perhaps inappropriate restrictions on the financial assets to which the overlay approach can be applied. In addition, the Board has previously found it difficult to identify specifically the assets relating to insurance contracts.

20. For example, the Board considered, but rejected, requiring entities that elect to use the overlay approach to apply it to all qualifying financial assets. That would be one approach to reduce inconsistent application of the overlay approach. However, the Board noted that there may be financial assets that meet the criteria for the overlay approach but, because of systems and process issues that affect them, the entity might reasonably decide that the cost of applying the overlay approach outweighs any benefits of reducing volatility in profit or loss (paragraph BC40). Accordingly, the Board concluded that entities should not be required to apply the overlay approach to all qualifying financial assets.

21. The staff considered the suggestion noted in paragraph 14, that the overlay approach should be limited to financial assets that are held by the same legal entity as the corresponding contracts within the scope of IFRS 4. However, the staff think that prohibiting entities from applying the overlay approach to financial assets held in legal entities that do not issue contracts within the scope of IFRS 4 is inappropriate because insurers may reasonably organise their assets in different ways, for example, an entity that issues contracts within the scope of IFRS 4 may have a subsidiary that holds and manages financial instruments that relate to the entity's IFRS 4 contracts. Nonetheless, we understand the concern that it may not be apparent why assets held by a legal entity in the group that does not issue contracts within the scope of IFRS 4

might be considered to relate to contracts within the scope of IFRS 4. Consequently, the staff propose to make such an occurrence transparent by requiring an entity to explain the basis for designating financial assets held by one legal entity as relating to contracts within the scope of IFRS 4, if those contracts are issued by a different legal entity within the same group (consistent with paragraph 37D(b) in the ED).

Clarifications about qualifying financial assets: surplus assets

22. The staff note that the Board intended that 'financial assets relating to contracts within the scope of IFRS 4' include:

    (a) financial assets that an entity holds to fund the settlement of liabilities arising from expected levels of claims and expenses; and

    (b) additional (or surplus) assets that an entity holds to meet regulatory, credit rating or its own (internal) capital requirements. The rationale for including surplus assets is that holding such assets is integral to an entity's insurance business. Also, any requirement to exclude surplus assets would likely result in an arbitrary split because insurers' investment systems often do not distinguish between surplus assets and those supporting insurance contract liabilities.

23. The issue of whether surplus assets could qualify for the overlay approach may not have been sufficiently clear in the ED when considering the number of questions in comment letters. Accordingly, the staff propose to clarify that those surplus assets could qualify, consistent with the Board's intention when it developed the proposals in the ED.

Clarifications about qualifying financial assets: other guidance

24. Several stakeholders sought more general guidance on what is meant by the qualifying criterion for a financial asset that 'is designated as relating to contracts that are within the scope of IFRS 4'.

25. The Basis for Conclusions on the ED (paragraph BC38) notes that entities would not be able to include in the overlay approach assets that are held in respect of activities

other than those associated with 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 financial assets held in funds relating only to investment contracts that are outside of the scope of IFRS 4 would not qualify for the overlay approach. Similarly, the staff believe that financial assets that an entity holds in defined pools/funds associated with contracts within the scope of IFRS 4 for regulatory or risk management purposes would generally be considered to relate to contracts within the scope of IFRS 4. However, the staff note that the Board has previously found it difficult to identify specifically the assets relating to insurance contracts. Therefore, apart from discussing assets that clearly are unrelated to contracts within the scope of IFRS 4, the staff do not believe it is feasible for the Board to provide more specific guidance on how an entity should identify assets relating to the scope of IFRS 4. It is for this reason that paragraph 37D(b) of the ED requires that an entity discloses its basis for determining the financial assets to which it applies the overlay approach.

26. Stakeholders did not raise concerns (other than drafting and editorial suggestions) about:

    (a) the mechanics of accounting for changes in the designation of financial assets (ie newly designating or de-designating previously recognised assets) that were proposed in paragraphs 35E (a) and (c) of the ED; and

    (b) the disclosures proposed in paragraphs 37C and 37D(a)-(d) of the ED[1].

27. Accordingly, the staff are asking the Board to confirm these aspects of the ED.

Questions—Qualifying financial assets for the overlay approach and related disclosures
1. Does the Board agree to confirm the ED proposals that: (a) A financial asset qualifies for the overlay approach if it is

[1] The Board received one comment on the disclosures in ED paragraph 37D(d) which the staff believe misunderstood the proposals and is not discussed further in this paper.

designated as relating to contracts that are within the scope of IFRS 4 and it is measured at fair value through profit or loss (FVPL) applying IFRS 9 but would not have been measured at FVPL in its entirety applying IAS 39 [paragraph 35B of the ED].

(b) An entity that applies the overlay approach:

(i) may newly designate a previously recognised financial asset as relating to contracts within the scope of IFRS 4 if and only if there is a change in the relationship between that financial asset and the contracts within the scope of IFRS 4. At the date of designation, the fair value of a financial asset newly designated as relating to contracts within the scope of IFRS 4 shall be its new amortised cost carrying amount. The effective interest rate for such a financial asset is determined based on its fair value at the date of designation.

(ii) shall de-designate a previously recognised financial asset as relating to contracts within the scope of IFRS 4 only when there is a change in the relationship between that financial asset and the contracts within the scope of IFRS 4.

(iii) shall reclassify to P&L any balance accumulated in OCI relating to a previously designated financial asset if and when that financial asset no longer meets the qualifying criteria above in sub-paragraph 1(a) [paragraph 35E (a)-(c) of the ED]

(c) An entity that applies the overlay approach is required to disclose sufficient information to enable users of financial statements to understand how the amount of the adjustment is calculated and the effect of the adjustment on the financial statements. In order to achieve this objective, an entity is required to disclose

(i) the fact that it has applied the overlay approach in the

reporting period and the carrying amount and classes of financial assets to which the reclassified amount relates;

(ii) its basis for determining assets to which the overlay approach is applied;

(iii) an explanation of the amount of the adjustment and the effect on the financial statements of changes in designation of financial assets during the reporting period?
[paragraphs 37C and 37D (a) – (d) of the ED].

2. Does the Board agree to:

(a) clarify that qualifying financial assets could include surplus assets that an entity holds for the purposes of regulatory, credit rating or internal capital requirements. Consequently surplus financial assets may be designated as relating to contracts within the scope of IFRS 4, as described in paragraph 35B of the ED.

(b) require that an entity explain, consistent with paragraph 37D(b) of the ED, the basis for designating financial assets held by one legal entity as relating to contracts within the scope of IFRS 4 that are issued by a different legal entity within the same group?

Presentation of the overlay adjustment

ED proposals

28. Paragraphs 35C and 37D(e) in the ED required that:

(a) the overlay adjustment should be presented as a separate line item in P&L, OCI or both; and

(b) the effect of the overlay adjustment on individual line items presented in the statement of profit or loss should be presented in the notes if it was not presented in P&L.

Feedback received in comment letters and other outreach

29. Stakeholders expressed mixed views about permitting entities to choose whether to present the overlay adjustment as a separate line item in P&L, OCI or both. However, many stakeholders said they would prefer that the Board specifies where the overlay adjustment should be presented instead of allowing presentation alternatives. Specifically:

    (a) Some preparers and users of financial statements did not object to and/or supported the proposed presentation alternatives in the ED. They thought that the approach to presenting the overlay adjustment that is chosen is not important as long as the information about it is provided on the face of the financial statements.

    (b) However, many stakeholders, including many regulators, standard setters and users of financial statements, believed that the Board should require an approach to presenting the overlay adjustment because they felt that a choice of presentation for an approach that is itself optional further reduces comparability.

30. Stakeholders expressed mixed views on which presentation alternative should be mandated. However, most stakeholders believed that the Board should require entities to present information in a way that will maximise comparability with entities that apply IFRS 9 without the overlay approach.

    (a) Many stakeholders, including regulators, standard setters and users of financial statements, believed that the line items in P&L related to financial instruments should reflect IFRS 9 information. That is because they believed that this would provide more useful information and improve

comparability with those using IFRS 9 without the overlay approach. In addition:

(i) Some users of financial statements emphasised that the overlay adjustment should be presented as a separate line item in P&L because it would make the adjustment more transparent and would send a clear signal that some amounts related to income and expenses are included in OCI.

(ii) Some stakeholders were confused about the proposal for the presentation alternatives because they thought paragraph 35A of the ED, which states that 'an entity reclassifies amounts from P&L to OCI', was a presentation requirement (whereas it was not intended to require particular presentation).

(b) Some users of financial statements believed that one approach to presenting the overlay adjustment should be mandated, but had no preference for what that should be.

(c) A few stakeholders believed that it would be better if entities presented information in P&L based on the requirements in IAS 39 because that would make it easier to observe trend information until the forthcoming new insurance contracts Standard is applied.

Staff analysis and recommendations

Presentation in P&L

31. The ED proposals would allow for alternatives for the presentation of the overlay adjustment in P&L. As explained in paragraph BC49 of the Basis for Conclusions, the Board did not specify a mandatory format to be consistent with the general principle in IAS 1. IAS 1 permits entities to determine the presentation that is most relevant to an understanding of the entity's financial performance. Consequently, the ED proposals would:

(a) permit an entity to determine the presentation that is most relevant to an understanding of its financial performance; and

(b) not restrict the presentation formats by:

    (i) prohibiting entities from presenting additional line items, headings and sub-totals; or

    (ii) requiring particular line items, such as a profit or loss subtotal determined applying IFRS 9.

32. However, in the light of the feedback received, the staff recommend that the Board should specify the presentation for the overlay adjustment. That is because of the following unfavourable consequences of permitting the presentation alternatives proposed in the ED:

    (a) Entities applying the overlay approach could present information in P&L differently compared with entities that apply IFRS 9 without the overlay approach and therefore comparability would be reduced. As noted above in paragraph 29(b), some stakeholders noted that permitting alternatives in presentation for an approach that is itself optional further reduces comparability and introduces complexity.

    (b) Entities applying the overlay approach could present 'mixed' information for financial assets. For example, an entity applying the overlay approach might present a single line item reflecting impairment losses measured in accordance with IFRS 9 for some financial assets and in accordance with IAS 39 for other financial assets. That presentation would likely be misleading and confusing for users of financial statements.

33. Specifically, the staff recommend that the presentation in P&L for financial assets to which the overlay approach is applied should reflect the application of IFRS 9, with a single, separate line item for the overlay adjustment. That is because:

    (a) Many stakeholders, including many users of financial statements, preferred (or did not object to) this presentation and said that it provides the most useful information. Also some noted that such presentation is more consistent with the objective of the overlay approach to apply IFRS 9 with additional information about the overlay adjustment.

(b) Such presentation would result in P&L presentation according to the same requirements (ie IFRS 9) for all of an entity's financial assets and therefore would enhance comparability with entities that apply IFRS 9 without the overlay approach and avoid possible confusion. This is especially important for financial conglomerates that will have financial assets to which the overlay approach is applied and financial assets to which IFRS 9 without the overlay approach is applied. Respondents suggested that the overlay approach would be mostly applied by financial conglomerates.

(c) Finally, as noted previously in this paper, some users of financial statements emphasised that a single line item in P&L for the effect of the overlay approach would make the adjustment more transparent and would send a clear signal that some amounts related to income and expenses are included in OCI.

34. The staff note that the single line item related to the overlay adjustment presented in P&L would comprise amounts reclassified from P&L to OCI and reclassified from OCI to P&L. Additional information about the amounts included in the overlay adjustment line item would be required to comply with the following paragraphs proposed in the ED and IAS 1:

(a) Paragraph 37D(d) of the ED proposed that a an entity should separately disclose specific amounts related to the change of the designated assets (see paragraph 13(d)).

(b) Paragraphs 92 and 94 of IAS 1 require an entity to present in OCI, or the notes, information about the reclassified amounts from OCI to P&L separately from information about amounts reclassified from P&L to OCI (see paragraph 37).

(c) Paragraph 37C of the ED proposed that an entity should disclose sufficient information to enable users of financial statements to understand the effect of that reclassification on the financial statements.

35. In addition, the staff note that the consequences of the recommendation on presentation in paragraph 33, together with the disclosure proposed in paragraph 37D(c) of the ED, is that an entity will be required to disclose the effect of the overlay adjustment on individual line items in the notes to the financial statements (ie an entity is prohibited from presenting those effects on the face).

Presentation in OCI

36. The staff note that paragraph 82A of IAS 1 requires an entity to present separate line items of OCI classified by nature. Consistent with this requirement, the staff recommend that an entity should be required to present the overlay adjustment separately from other components of OCI because the overlay adjustment is different in nature from other items included in OCI.

37. In addition, the staff note that other paragraphs of IAS 1 will apply to the presentation of the overlay adjustment reclassified from OCI to P&L. For example, paragraphs 92 and 94 of IAS 1 require an entity to present reclassification adjustments relating to components of OCI in OCI or in the notes (an entity presenting reclassification adjustments in the notes presents the items of OCI after any related reclassification adjustments).

Question - Presentation of the overlay adjustment

3. Does the Board agree to amend the ED proposals in paragraphs 35C and 37D(e) concerning the presentation of gains and losses for financial assets to which the overlay approach is applied to require:

   (a) an entity to present:

      (i) in P&L, information that reflects the application of IFRS 9, with a single, separate line item for the overlay adjustment; and

      (ii) in OCI, the overlay adjustment separate from other components of OCI consistently with IAS 1; and

   (b) an entity to disclose the effect of the overlay approach on individual line items in the notes to the financial statements?

Other aspects of the overlay approach

38. The staff are also asking the Board to confirm the ED proposals for the overlay approach that did not attract a significant amount of comment, ie, proposals concerning:

    (a) initially applying, and ceasing to apply, the overlay approach [paragraphs 35D, 35E(d) and 35F of the ED];

    (b) applying the overlay adjustment to pre-tax profit or loss [paragraph BC24 of the ED]; and

    (c) transition to the overlay approach [paragraph 41K of the ED].

Initial application of or ceasing to apply the overlay approach

39. The ED proposes that an entity may elect to apply the overlay approach only when it first applies IFRS 9 or when it applies IFRS 9 after previously applying only the 'own credit' requirements in IFRS 9 for financial liabilities [paragraph 35D of the ED]. As a consequence, an entity, that does not have contracts within the scope of IFRS 4 when it first applies IFRS 9, is not permitted to apply the overlay approach in subsequent periods if the entity does have contracts within the scope of IFRS 4.

40. The ED proposes that an entity can stop applying the overlay approach at the beginning of any annual reporting period. An entity that stops applying the overlay approach shall apply IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to account for the change in accounting policy [paragraph 35E(d) of the ED]. The ability to stop applying the overlay approach reflects the Board's view that entities should not be prevented from applying IFRS 9 without the overlay approach.

41. The ED proposes that an entity that stops applying the overlay approach because it chooses to do so, or because it no longer issues contracts within the scope of IFRS 4, would not subsequently be permitted to use the overlay approach. An entity that temporarily stops using the overlay approach because it no longer has qualifying financial assets would, however, subsequently be permitted to apply the overlay approach [paragraph 35F of the ED]. This reflects the Board's view that the overlay

approach is a transitional relief for entities that have not previously applied IFRS 9 in conjunction with their existing accounting under IFRS 4. An entity that chooses to stop applying the overlay approach gives up the right to transitional relief. An entity that starts to apply IFRS 4 when it already applies IFRS 9 (ie the case set out in paragraph 39 above) can use the flexibility provided by IFRS 4 (eg, use of current discount rates) to avoid or minimise the effect of accounting mismatches in profit or loss. So the staff recommend that these proposals in the ED be confirmed without amendment.

Applying the overlay adjustment to pre-tax profit or loss

42. The Basis for Conclusions of the ED (paragraph BC 24 of the ED) explained that the overlay adjustment adjusts pre-tax profit or loss. This would enable users of financial statements to compare P&L before tax on a consistent basis regardless of whether the entity applies the overlay approach. The staff think that this rationale is still valid and proposes that this proposal be confirmed.

43. The staff note that any tax consequences of the overlay adjustment would be accounted for applying IAS 12 *Income Taxes* and IAS 1. Applying those Standards, an entity would:

    (a) Present the tax expense (income) related to profit or loss from ordinary activities as part of P&L (paragraph 77 of IAS 12) as a separate line item (paragraph 82(d) of IAS 1).

    (b) Recognise the tax expense outside of P&L if the tax relates to items that are recognised outside of P&L (paragraph 61A of IAS 12) and items of OCI should be presented either: (1) net of related tax effects, or (2) before related tax effects with one amount shown for the aggregate amount of income tax relating to those items (paragraph 91 of IAS 1).

Transition to the overlay approach

44. The ED proposes that an entity that applies the overlay approach shall:

(a) Apply that approach retrospectively to qualifying financial assets on transition to IFRS 9; and

(b) restate comparative information to reflect the overlay approach if and only if the entity restates comparative information in accordance with IFRS 9 [paragraph 41K of the ED].

Because an entity that applies the overlay approach also applies IFRS 9, those proposals are consistent with the transition requirements of IFRS 9. The staff recommend that the ED proposals for transition to the overlay approach be confirmed without amendment.

Questions—Other aspects of the overlay approach
4. Does the Board agree to confirm the ED proposals on: (a) the initial application of, and ceasing to apply, the overlay approach [paragraphs 35D, 35E(d), and 35F of the ED]; (b) applying the overlay adjustment to pre-tax profit or loss [paragraph BC 24 of the ED]; and (c) transition to the overlay approach [paragraph 41K of the ED]?