Different effective dates of IFRS 9 *Financial Instruments* and the new insurance contracts Standard

Proposed amendments to IFRS 4

CMAC meeting

25 February 2016

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Objective

- The purpose of this session is to understand investors' views on the proposals that seek to address concerns about different effective dates of the new accounting requirements for financial instruments and insurance contracts.
- Our objective is to ensure that users of financial statements are provided with useful information about entities that issue insurance contracts.
- Those proposals:
  - permit *all* insurers to adjust profit or loss to remove any additional volatility (the Overlay Approach); and
  - permit *some* insurers to defer the application of the new accounting requirements for financial instruments (the Deferral Approach).

Background

- The Board expects to finalise a new insurance contracts Standard in 2016
  - The new Standard will introduce consistent accounting for all insurance contracts and require entities to measure insurance contracts on a current basis.
  - The forthcoming changes will likely not be effective before 2020.
- In July 2014, the Board issued IFRS 9 *Financial Instruments*
  - IFRS 9 sets out financial reporting requirements for financial instruments and is effective from 1 January 2018
  - IFRS 9 sets out a more logical classification model with complex financial assets measured at fair value, a better impairment model and more flexible hedge accounting
- Some raised concerns about different effective dates of IFRS 9 and the new insurance contracts Standard
  - the complexity of two consecutive major accounting changes; and
  - additional volatility in profit or loss that could arise when the new accounting requirements for financial instruments are applied in conjunction with the current accounting requirements for insurance contracts
- Some suggested that the effective date of IFRS 9 should be deferred for insurers and aligned with the effective date of the new insurance contracts Standard

Timeline

Flexibility of both IAS 39* and IFRS 4** do not give rise to concerns about accounting volatility in profit or loss

Interaction of IFRS 9 and IFRS 4 may result in increased accounting volatility in profit or loss

Interaction of IFRS 9 and the new insurance contracts Standard assists in reducing accounting volatility in profit or loss

Effective date of IFRS 9
1 January 2018

Effective date of the new insurance contracts Standard
– not before 2020

IAS 39 + IFRS 4

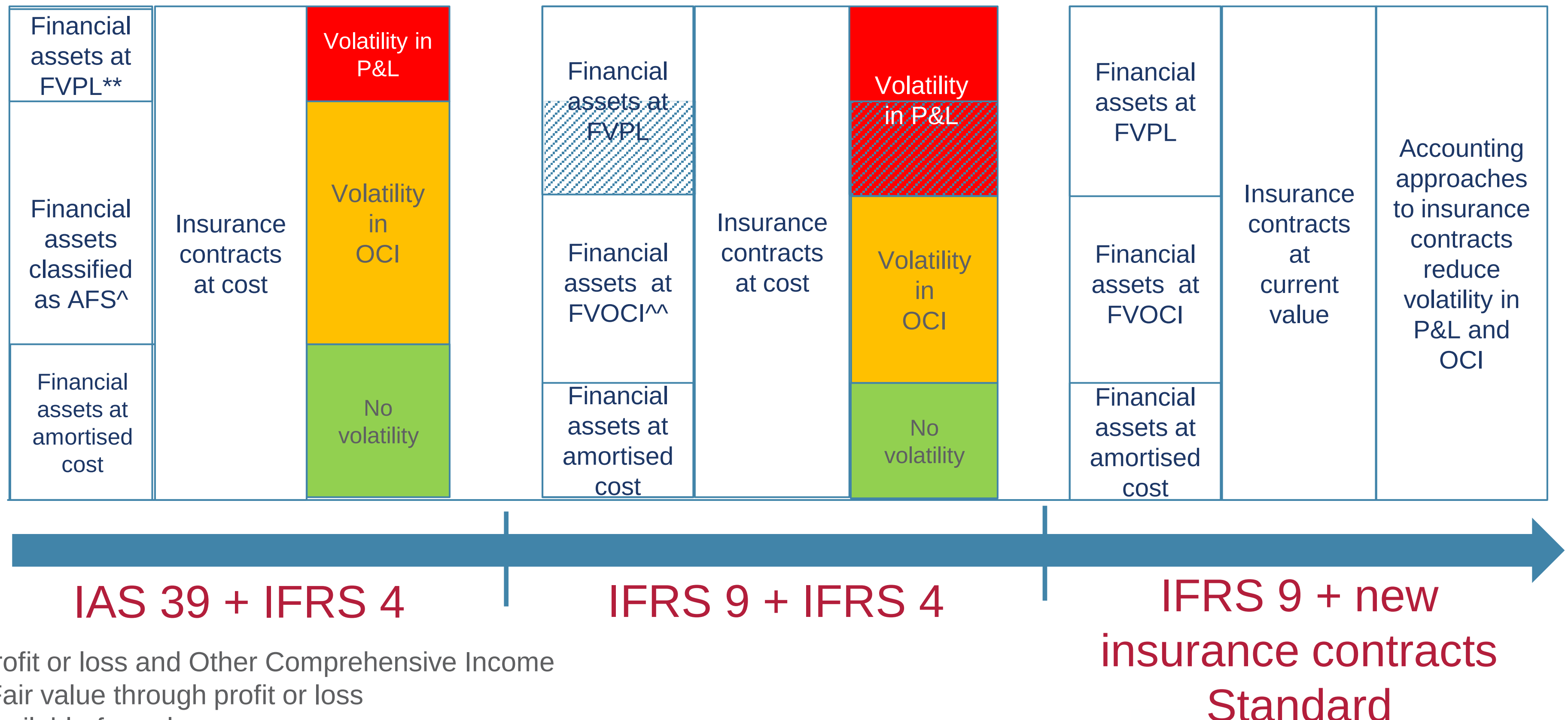
IFRS 9 + IFRS 4

IFRS 9 + new insurance contracts Standard

*IAS 39 *Financial Instruments: Recognition and Measurement* is pre-IFRS 9
**IFRS 4 *Insurance Contracts* sets out the current accounting requirements for insurance contracts

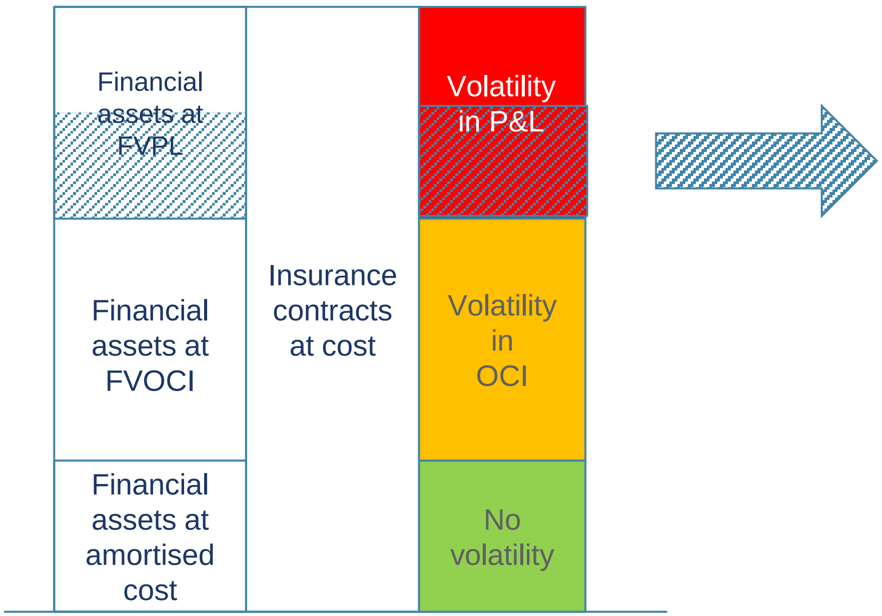
Why volatility in profit or loss may increase: illustration

- The charts below illustrate the interaction of accounting for financial assets and insurance contracts
- Volatility in P&L and OCI* may comprise accounting & economic mismatch between financial assets and insurance contracts
- The shaded area on the second chart represents the increased volatility in P&L that could arise for some entities
- *The sizes of boxes do not represent the relative size of different populations; they are used merely for illustration*



*Profit or loss and Other Comprehensive Income
**Fair value through profit or loss
^Available-for-sale
^^Fair value through OCI

Potential sources of increased volatility in profit or loss



IFRS 9 + IFRS 4

Examples of financial assets measured at FVPL under IFRS 9 that would not be so measured under IAS 39:

- Structured debt
- Convertible debt
- Puttable investments in mutual funds
- Equity investments (if an entity does not select OCI option)

For many assets, classification may not change when IFRS 9 is applied

Note: Insurers use a variety of models to account for insurance contracts

Question 1: Different effective dates

Do you have concerns about different effective dates of IFRS 9 and the new insurance contracts Standard, in particular about:

A. Any increased volatility in profit or loss that could arise for some insurers?
B. Two consecutive major accounting changes?

Why or why not? Do you agree that the Board should address those concerns?

IFRS Standards

The Overlay Approach

An option for *all* entities that issue insurance contracts that applies to *some* of their financial assets

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The Overlay Approach Overview

- IFRS 9 is applied from 1 January 2018
- All insurers are permitted to adjust P&L and to reclassify to OCI
  - the difference between the amounts recognised under IFRS 9 and the amounts that would have been recognised under IAS 39
  - for financial assets that are designated as related to insurance activities and are measured at FVPL under IFRS 9 and would not be so measured under IAS 39
- Presentation of the overlay adjustment
  - as a *separate* line item or *within* the adjusted line items in profit or loss,
  - however, must be a separate line item in OCI if not so presented in profit or loss
- The objective is to remove from profit or loss any increased volatility in a transparent and consistent manner

Statement of Comprehensive Income

	20XX
Profit or loss	
Insurance contracts revenue	X
Incurred claims and expenses	(X)
Operating result	X
Investment income	X
Interest on insurance liability	(X)
Investment result	X
…	
Profit or loss	**X**
Other comprehensive income	X
Overlay adjustment	X
Total comprehensive income	**X**

IFRS®

The Overlay Approach Disclosure

- Enable users of financial statements to understand how the overlay adjustment is calculated and its effect on the financial statements
  - The fact that the entity applied the overlay approach
  - The basis for determining the financial assets to which the overlay approach is applied
  - Carrying amounts and classes of the financial assets to which the reclassified amount relates
  - An explanation of how the amount reclassified from profit or loss was derived and the effect of the reclassification on each line item in profit or loss
  - The information about effects of any changes in designated financial assets in a reporting period

Question 2: The Overlay Approach

A. In your view, does the Overlay Approach represent an acceptable approach to addressing concerns about different effective dates of IFRS 9 and the new insurance contracts Standard? Would that approach provide useful information? Why or why not?

B. Do you agree that the Overlay Approach should apply to financial assets that are designated as related to insurance activities and are measured at FVPL as a result of applying IFRS 9?

C. In your view, would the proposed presentation and disclosure requirements enable meaningful comparison between entities that apply the Overlay Approach and those that do not? If not, what other presentation and disclosure requirements would be useful?

IFRS Standards

The Deferral Approach

An option for *some* entities that issue insurance contracts that applies to *all* of their financial assets

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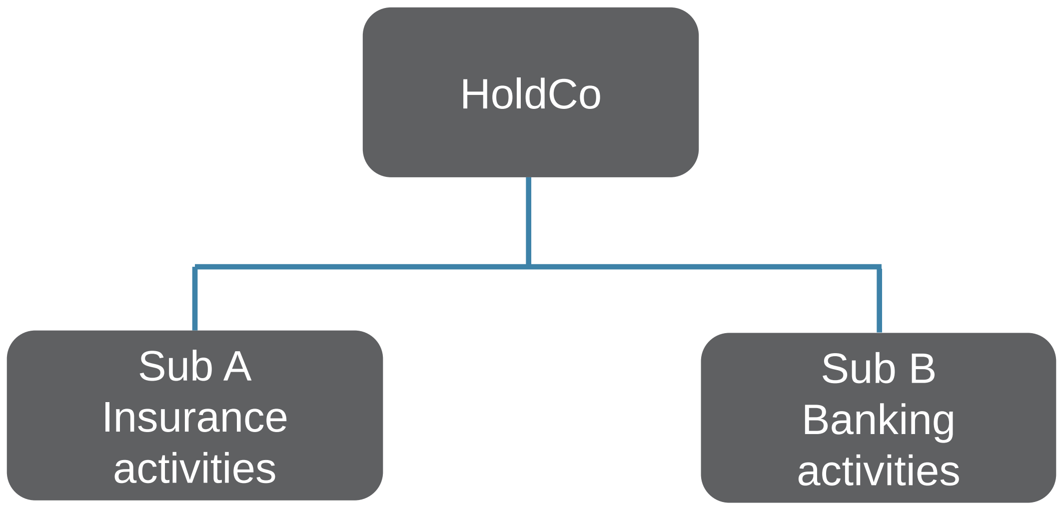
The Deferral Approach
Predominant activity

- Applied to the entity as a whole and available for ‘pure’ insurers only
- Insurance activity must be predominant for the entity
- Predominance is assessed based on the entity’s liabilities from insurance contracts
- If one quarter of the entity’s activities is <u>not</u> insurance (eg banking)
  - the predominance condition would not be met
  - the entity would not be permitted to apply the deferral

The Deferral Approach Illustration

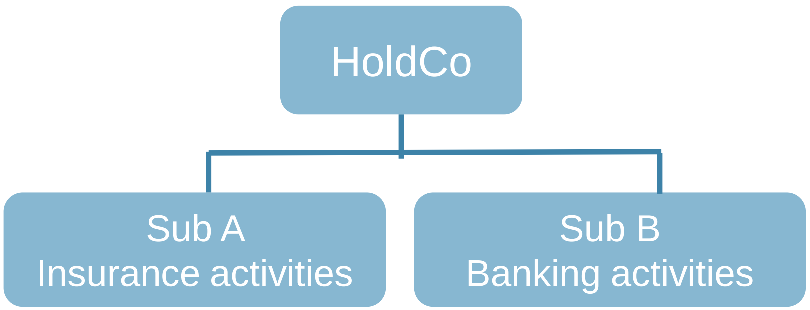
- Consider a financial conglomerate that issues insurance contracts and undertakes banking activities.



The Deferral Approach
Reporting entity level

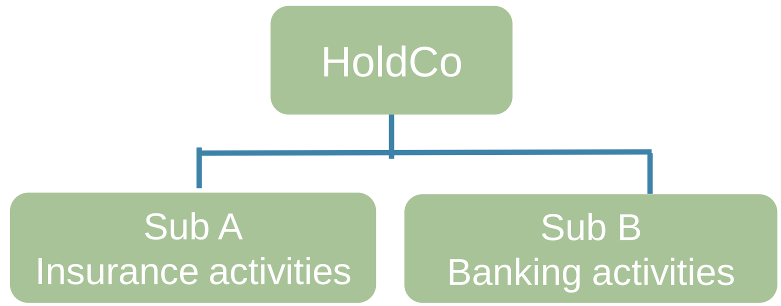
IFRS 9 IAS 39

- If the predominant activity of the conglomerate is insurance business



- The conglomerate is permitted continue to apply IAS 39 to **all** financial assets in consolidated financial statements
- Note: if Sub B publishes standalone financial statements it must apply IFRS 9 to **all** financial assets

- If the predominant activity of the conglomerate is NOT insurance business



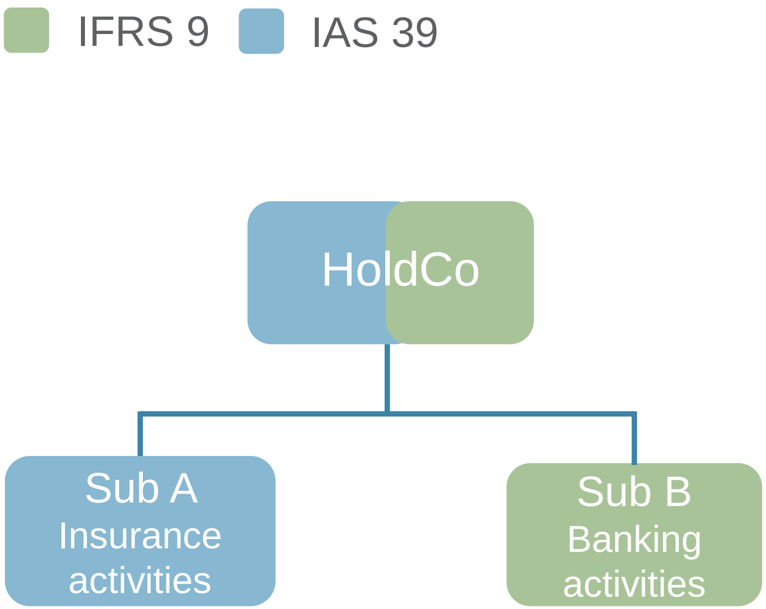
- The conglomerate must apply IFRS 9 to **all** financial assets in consolidated financial statements
- Note: if Sub A publishes standalone financial statements it is permitted continue to apply IAS 39 to **all** financial assets

The Deferral Approach
Disclosure and expiry date

- Disclosure
  - The fact that the entity applied the Deferral Approach and how it is concluded it is eligible
  - Selected IFRS 9 information:
    - Fair value of financial assets that are not considered ‘simple’ under IFRS 9 (ie cash flows are not solely payments of principle and interest)
    - Information about credit risk exposure for financial assets that are considered simple and are subject to impairment under IFRS 9, and their gross carrying amounts by credit risk rating grades
  - Information about changes in predominant activity of the entity in the reporting period

- Expiry date
  - The Deferral Approach can only be applied until 1 January 2021 – all entities must apply IFRS 9 from that date

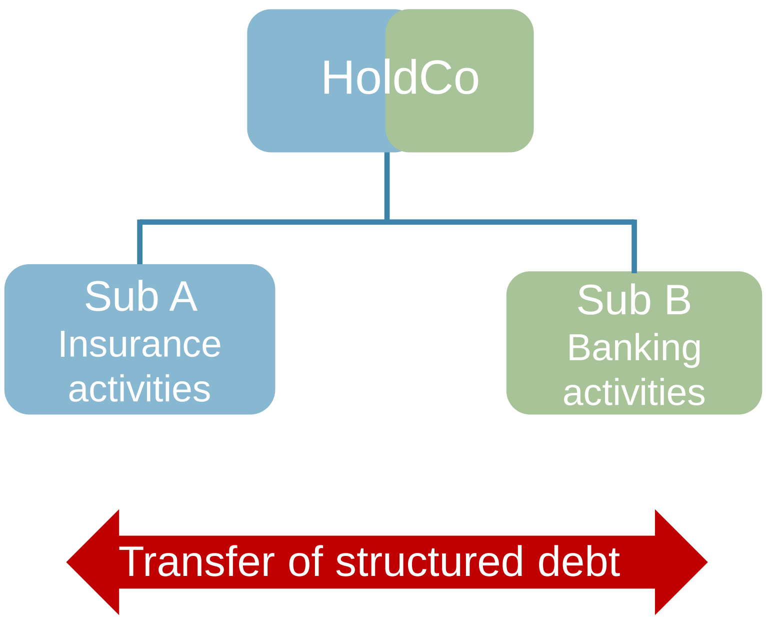
Alternative approaches considered
Deferral **below** reporting entity level



- In its consolidated financial statements, the conglomerate
  - could continue to apply IAS 39 to financial assets that relate to insurance activities
  - would be required to apply IFRS 9 to financial assets that do NOT relate to insurance activities
- In the standalone financial statements
  - Subsidiary A could continue to apply IAS 39
  - Subsidiary B would be required to apply IFRS 9
- Challenges
  - Financial assets that relate to insurance activities
    - Legal structure and predominant activity
    - Legal structure and regulation
    - Segment reporting
  - Different requirements for identical financial assets
  - Transfers of financial assets (Slide 18)

Deferral below reporting entity level Asset transfers*

IFRS 9 IAS 39



*Such transfers may not happen often in practice

- Suppose Sub A that applies IAS 39 sells a structured debt investment to Sub B that applies IFRS 9
- Sub A bifurcated the structured debt under IAS 39. The bifurcated derivative was measured at FVPL and the host was measured at amortised cost
- Subsidiary B already holds identical structured debt investments and measures them at FVPL under IFRS 9
- In the consolidated financial statements of the conglomerate that applies both IAS 39 and IFRS 9:
  - If IAS 39 accounting <u>'travels'</u> with the transferred investment, identical investments in the banking subsidiary will be accounted for differently;
  - If accounting model <u>changes</u> to IFRS 9 on a transfer of the investment, that could lead to recognition of gains and losses on internal transfers.

The Deferral Approach
Basis for the proposals

- Feedback received by the Board in its outreach with investors in developing the proposals
- Complexity and confusion and arbitrage opportunities as a result of applying different accounting requirements (ie both IAS 39 and IFRS 9) in one set of financial statements
- Improved accounting for financial instruments required for most entities
- Overlay Approach available to all entities that issue insurance contracts

Question 3: The Deferral Approach

A. In your view, would the Deferral Approach for entities whose predominant activity is insurance provide useful information? Why or why not? If not, what would you propose instead?

B. Do you agree that predominant activity is assessed based on the level of liabilities under insurance contracts? If not, what do you propose instead?

C. Do you agree that the Board should seek to avoid simultaneous application of IFRS 9 and IAS 39 in one set of financial statements?

D. In your view, would the proposed disclosures enable meaningful comparison between entities that apply the Deferral Approach and those that do not? If not, what other disclosures would be useful?

E. Do you agree that the Deferral Approach should only be available for a short period of time after IFRS 9 becomes effective, specifically until 1 January 2021? If not, why?

All proposals

Question 4

In your view, should entities be permitted or required to apply the Overlay Approach and the Deferral Approach? Why?

Question 5

In your view, should both the Overlay Approach and the Deferral Approach be permitted? Alternatively, do you think that only one approach should be permitted and if so, which one? Why?

Next steps

- ED published on 8 December 2015
- Comment period ended 8 February 2016
- Re-deliberation and publication of final amendments to IFRS 4 in 2016

Thank you

We welcome your feedback

The views expressed in this presentation are those of the presenter. Official positions of the Board on accounting matters are determined only after extensive due process and deliberation.