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Investor Perspectives

Mind the gap?

Sue Lloyd

A member of the IASB, discusses proposed amendments to IFRS 4 *Insurance Contracts* to provide temporary relief for insurers and also discusses the importance of investor involvement during the comment period.

After many years of extensive consultation the IASB is close to finalising its new accounting Standard for insurance contracts. The good news, particularly for those using the financial statements, is that when that Standard comes into effect, insurance contracts will be accounted for on a consistent basis under IFRS. In addition, everyone using IFRS will measure their liabilities for insurance contracts on an updated current measurement basis on the balance sheet (ie insurance contracts liabilities would be discounted using current discount rates).

The not quite so good news is that the earliest that this change in accounting is likely to be reflected in financial statements is 2020. In the meantime the new financial instruments accounting under IFRS 9 *Financial Instruments* is due to come into effect—it is mandatory from 2018. Some have raised concerns about this and are calling on the IASB to 'mind the gap' in timing. The question we have for you is whether we should 'mind the gap' and if so how should we do that?

So what is the concern?

Insurers are concerned about the fact that IFRS 9 will apply before they change the way in which they account for their insurance contracts. A key concern insurers raise (primarily those that measure their insurance contract liabilities today on a cost basis), is that some of their financial assets may change to being measured at fair value through profit or loss when they apply IFRS 9. The types of financial assets that they have in mind are structured debt and equity investments.

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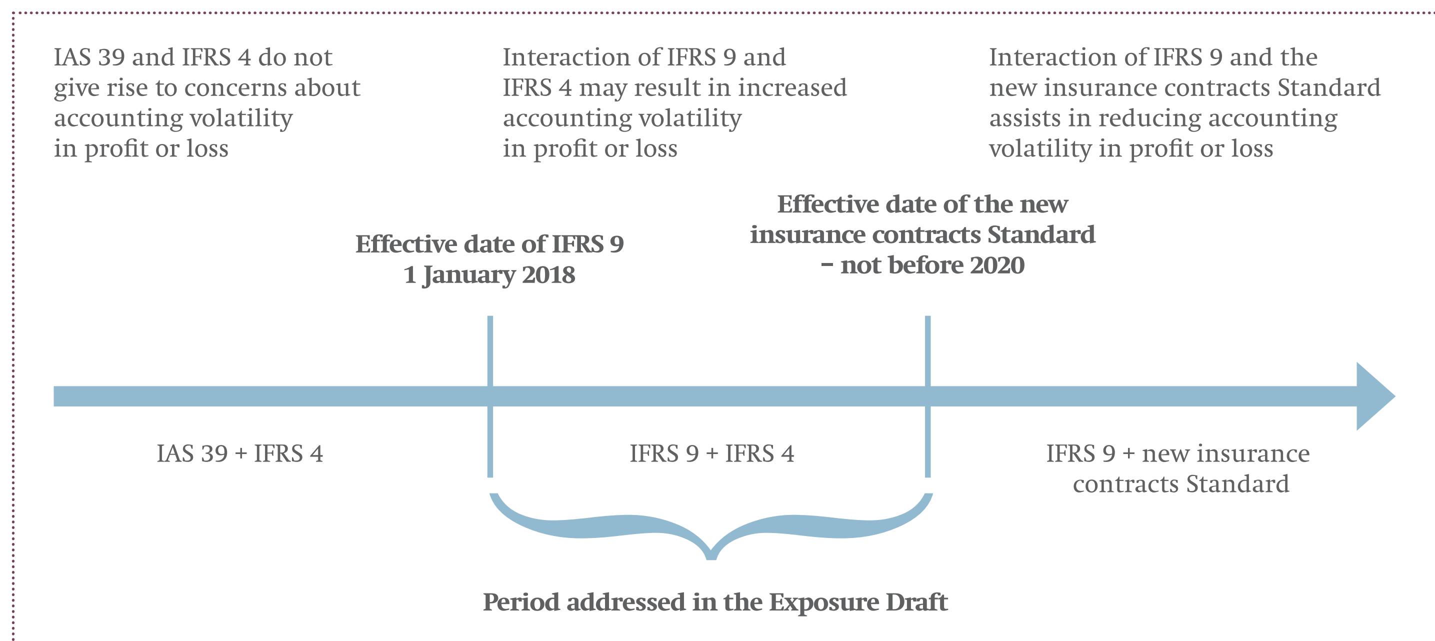
This would mean, for example, that for structured, debt changes in fair value, including those caused by changes in interest rates, would be reflected in profit or loss. Ultimately, some of the additional volatility in profit or loss that arises from this may be offset when they move to current measurement of liabilities for insurance contracts, at which time interest rate changes on the liability could be reflected in profit or loss. The insurers who have raised this are concerned about the volatility in this interim period. In particular, they are concerned that this short-lived volatility, along with two changes in accounting in relatively quick succession, may confuse users of the financial statements. These concerns have led many insurers to call on the IASB to defer the application date of IFRS 9 for them.

IFRS

Figure 1: Timeline for implementation of IFRS 9 and the new insurance contracts Standard



The IASB did some targeted outreach with investors and analysts during August 2015 to find out directly whether this is indeed a concern for those using the financial statements. That preliminary outreach showed a mix of views on the need to do anything about the gap in timing. Some investors, in fact, felt that it could be helpful to see the effect of IFRS 9 and to digest that before subsequently seeing the effect of changing the approach to measuring insurance contracts. Others noted that they are already accustomed to seeing additional explanations of volatility by insurers, so this was really 'more of the same'. Some did, however, share the concern that having this effect for a short period and having two sets of changes, which would upset trend analysis, was not helpful.[1] We are very keen to hear more views on this to assist in finalising our position on this issue.

What the IASB is proposing

IFRS 9 introduces substantial improvements to the accounting for financial instruments. In particular, IFRS 9 introduces a more forward-looking expected credit loss model. This is an important response to the financial crisis and it is desirable that this impairment model is applied on a timely basis. The IASB is therefore concerned about any deferral of IFRS 9 that has broad applicability. With this in mind it has developed proposals that seek to ensure that as many entities as possible apply IFRS 9 from 2018 while targeting the concerns raised. It is difficult to achieve this, because separating out those financial assets that relate only to insurance activities is complicated, particularly in the case of reporting entities that conduct a range of business activities such as conglomerates.

Two approaches are proposed that are designed to co-exist: the deferral approach and the overlay approach.

Deferral approach

The IASB proposes that a deferral of IFRS 9 be allowed, but only for reporting entities that are predominantly insurers—ie it would be available to a 'pure insurer'. This narrow scope is consistent with the IASB's objective of targeting the concerns raised. It also reflects the fact that many users of financial statements we have spoken to do not think any action is necessary and many dislike the idea of any deferral of the application of IFRS 9.

1 A paper summarising the findings of the targeted outreach is available at: http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/September/AP14A-IFRS%209%20and%20IFRS%204.pdf

The IASB proposes that the test of predominance should be a high hurdle and be based on a comparison of the amount of insurance contract liabilities and the entity's total liabilities. The assessment of predominance would require judgement. However, we indicate that if 75 per cent of an entity's liabilities related to insurance contracts and the rest did not, for example they relate to banking, that would not be high enough and the entity would not be predominantly considered to be an insurer. We believe having such a high hurdle should ensure that only those entities that are 'pure insurers' will be eligible for the deferral approach.

Some ask why we have proposed to set the test with such a high hurdle. The short answer is that having some entities (such as banks) applying IFRS 9 to their financial assets and other significant holders of financial assets applying IAS 39 affects comparability. Although we have often heard that insurers are compared with other insurers (or with insurance 'segments'), many investors have told us that it is important to be able to make comparisons between holders of similar assets regardless of the identity of the holder. Having a high hurdle restricts the number of entities that will not be reporting using IFRS 9. Consequently, this is an intentionally narrow group of entities that are most affected by the concerns raised.

If an entity that qualifies for the deferral of IFRS 9 chooses to continue to apply IAS 39 this choice applies to all of its financial instruments — not only those financial assets related to its insurance activities. We have not proposed to allow an entity to apply a combination of IAS 39 and IFRS 9 in its financial statements (for example, using IAS 39 for its insurance businesses and IFRS 9 for other parts of its business) for various reasons, including concerns raised by many investors we have spoken to so far about the risk of gains and losses being booked as a result of transferring assets internally.

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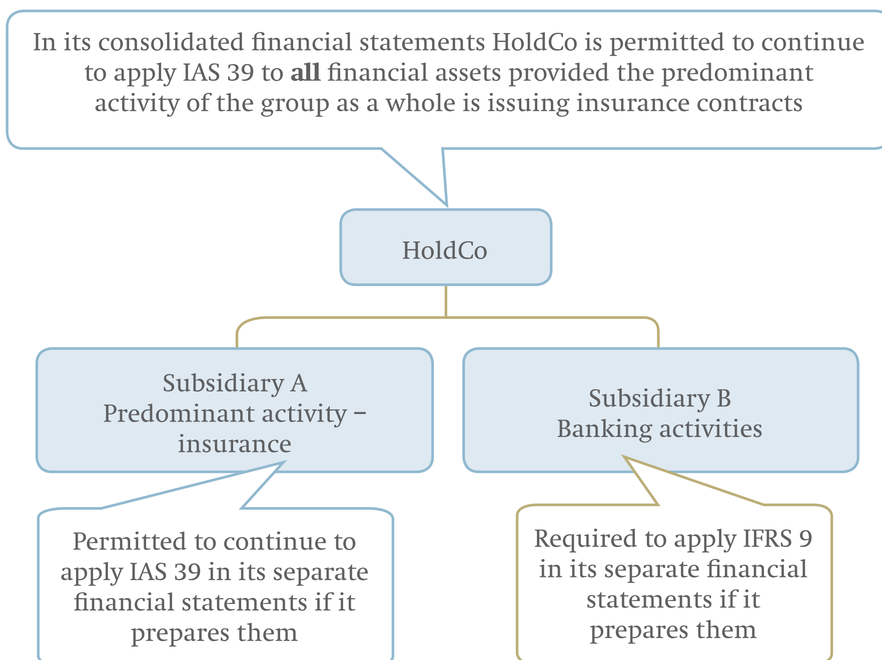
The IASB proposes that an entity that qualifies for the deferral should have the choice of whether or not to apply IFRS 9 rather than making deferral mandatory. Unfortunately this was not the preference of most investors that we have spoken to. Most would prefer any deferral to be mandatory, so that accounting for financial assets by those eligible for deferral is at least consistent. The IASB shares this concern. However, the IASB noted that it was very difficult to mandate deferral. One of the factors discussed that may not have been considered by all investors, is that there is significant diversity between insurers in how they measure insurance contracts today. Some already measure their insurance contracts on a current basis so may not have the same need for deferral of IFRS 9.

In addition, in terms of implementation of IFRS 9, some entities are already down the path of implementing IFRS 9 or may indeed have implemented it already, so would incur costs and/or be inconvenienced by deferral. Others may simply prefer to move to the improved IFRS 9 accounting as soon as they can. Given such considerations, it was decided that while the decision was a difficult one, it would be inappropriate to mandate deferral.

Any deferral of IFRS 9, no matter how narrow its scope, causes issues with comparability between entities. Also a key reason for the deferral requests (and for the IASB's willingness to consider this) was that the new accounting for insurance contracts accounting is expected to apply only a few years after 2018, (ie when IFRS 9 becomes mandatory). To 'mind the gap' the IASB thus proposes that rather than being open-ended, the deferral has a limited life — so at the latest all entities would be required to apply IFRS 9 from 2021. Thus any lack of comparability at least would have a limited life.

To enable comparison between those that apply IFRS 9 and those that do not, it is proposed that some key IFRS 9 related disclosures should be provided by those who choose to defer application of IFRS 9 – these include information about the fair values of financial assets that would be required to be measured at fair value under IFRS 9 because they are not treated as 'simple debt instruments'.

Figure 2: The deferral approach



Overlay approach

The proposed deferral would assist those who are essentially insurance companies. However, the new insurance contracts accounting applies to a different population. It will affect all entities that issue insurance contracts even if that is only a small part of their business and/or they are not regulated as insurers. As a result the deferral may not be available to all who could be affected by the difference in timing between IFRS 9 and the new insurance contracts Standard. In addition, not all entities that qualify for the deferral may wish to actually defer the application of IFRS 9. As a result of this the IASB has also proposed an 'overlay' approach in the Exposure Draft that is designed to be available in addition to the option to defer the application of IFRS 9.

An entity that uses the overlay approach would be required to apply IFRS 9. Consequently, comparisons could be made with all other entities applying IFRS 9—in particular the balance sheet carrying amounts of financial assets would reflect IFRS 9 classification and measurement. However, entities could choose to adjust their profit or loss to revert to an IAS 39 effect for those assets that relate to insurance contracts and that are newly measured at fair value through profit or loss as a result of applying IFRS 9. In effect the overlay would remove the incremental volatility introduced by IFRS 9 for those assets. The incremental amount adjusted or 'removed from' profit or loss would be recognised in other comprehensive income.

It is proposed that entities applying the overlay approach would have to provide information about the line item effects of the adjustment made to profit or loss. This could be provided either on the face of the financial statements or in the notes to the financial statements. So an entity may choose to provide a single line adjustment for the effect of the overlay (item F in Alternative 1 in the illustration below) to get to an adjusted profit or loss figure, or to present the adjustment for the effect of IAS 39 on a line-by-line basis (this would be investment income portrayed as D+F in Alternative 2 in the illustration below).

However, irrespective of the approach taken, a single line item for the amount of the adjustment would be required to be provided on the face of the financial statements (either in the profit or loss statement or in other comprehensive income). So an entity that shows the adjusted investment income line item in Alternative 2 in the illustration below would be required to show (F) within other comprehensive income. The IASB decided to allow this presentation choice along with mandating a single line disclosure on the face to encourage entities to provide the view of their performance that they consider is most meaningful, while ensuring that the effect of the overlay is very visible for those using the financial statements.

The IASB proposes that the overlay approach be available for all entities that issue insurance contracts even if that is only a small part of their business and/or they are not regulated as insurers

Illustration of the Overlay Approach

Statement of Comprehensive Income			
	20XX	20XX	20XX
	No overlay	Alternative 1 Overlay presented as a single line item in profit or loss	Alternative 2 Overlay presented within individual line items in profit or loss
Insurance contracts revenue	A	A	A
Incurred claims and expenses	(B)	(B)	(B)
Operating result	C = A-B	C = A-B	C = A-B
Investment income	D	D	D+F
Interest on insurance liability	(E)	(E)	(E)
IFRS 9 overlay adjustment		F	
Profit or loss	G1 = C+D-E	G2 = C+D-E+F	G2 = C+D-E+F
IFRS 9 overlay adjustment		(F)	(F)
Total comprehensive income	G1 = C+D-E	G1 = G2-F	G1 = G2-F

* Comparability between entities that apply the overlay approach and those that do not is ensured by transparent presentation of the overlay adjustment in profit or loss, other comprehensive income or both.

If an entity chooses to apply the overlay approach, rather than providing users of financial statements with less IFRS 9 information, as would be the case for those who defer the application of IFRS 9, more information is provided to users of the financial statements. For those assets subject to the overlay approach, IFRS 9 information would be provided and in *addition*, information would be provided about the incremental effect on profit or loss of applying IFRS 9 rather than IAS 39. The effect on the financial statements and the types of assets subject to the overlay is summarised in the table below. This shows that an entity can choose to apply the overlay approach in cases in which the measurement of the financial asset was previously other than FVPL in its entirety and it is now FVPL:

IFRS 9 measurement	IAS 39 measurement	Overlay available?	Balance sheet information	Profit or loss information
FVPL debt or equity (no impairment accounting)	• Amortised cost (with incurred loss impairment) • Available-for-sale (AFS) debt or equity (with incurred loss impairment) • Bifurcated asset – amortised cost or AFS host (with incurred loss impairment) & FVPL derivative • Equity investments at cost and derivatives on such investments	Yes	IFRS 9 fair value information	IFRS 9 fair value information *and* overlay adjustment to provide IAS 39 information ie: • Amortised cost (with incurred loss impairment) • AFS debt or equity (with incurred loss impairment) • Bifurcated asset – amortised cost or AFS host (with incurred loss impairment) & FVPL derivative • Impairment and gains and losses on sale of equity investments at cost and derivatives on such investments
FVPL	FVPL	No	Fair value	Fair value
Amortised cost (with expected loss impairment)	Any category	No	Amortised cost	Amortised cost (with expected loss impairment)
FVOCI (with expected loss impairment)	Any category	No	Fair value	Amortised cost (with expected loss impairment)
OCI equity	AFS	No	Fair value	Dividends

As the table shows, for all assets subject to impairment accounting, the new more forward-looking expected loss impairment accounting in IFRS 9 would apply. For financial assets that were previously subject to impairment accounting, this no longer would be the case (because they are now measured at fair value through profit or loss when applying IFRS 9), the IAS 39 effect in P&L reflects incurred loss impairment accounting. As a result only one type of impairment would ever be provided for an asset —but the basis for that impairment calculation would vary as shown above. This decision was made to meet the information needs of investors while avoiding the need for preparers to apply the new expected loss impairment requirements to a broader population of assets than IFRS 9 requires.

The IASB proposes that an entity that issues insurance contracts could designate those assets associated with its insurance contracts to which it wishes to apply the overlay approach to. This was partly a practical decision because there is often no formal link between financial assets and insurance contracts. In addition, because the overlay approach increases the amount of information available to users of financial statements the IASB felt that a more flexible approach was acceptable.

We need your views

The proposal to try to address the gap in timing between when IFRS 9 applies and when the accounting for insurance contract changes has largely been based on the argument that this gap causes complications for those using insurers' financial statements. Does it really? Your views on this would help us to substantiate this claim.

On balance the IASB considers that there could be added complexities caused by this timing mismatch so we have proposed some ways to address this. Do you agree with the proposal to allow some to continue applying IAS 39 and only apply IFRS 9 at a later date? If so, have we targeted the right population?

Do you agree that the overlay approach would provide information that could be helpful for you in understanding the effect of IFRS 9 in the period prior to the change in insurance contracts accounting? Is the way that this would be presented in the financial statements going to be useful to you?

These proposals are designed to help you – the people reading the financial statements and making decisions based on them. We would like to hear your views and comments on this issue.

Given that IFRS 9 must be applied from 2018 we need to make decisions on these issues quickly. These proposals are open for comment until 8 February 2016. Please let us know what you think.

Get in touch

To submit a comment letter, please visit: go.ifrs.org/comment_AC

If you would like to discuss this topic or other areas of accounting, please contact:
Sue Lloyd at slloyd@ifrs.org or
Barbara Davidson, IASB Investor Liaison, at bdavidson@ifrs.org

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