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Exposure Draft ED/2015/11

Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts

Proposed amendments to IFRS 4

Comments to be received by 8 February 2016

IASB[®]

 IFRS[®]

Applying IFRS 9 *Financial Instruments* with
IFRS 4 *Insurance Contracts*
(Proposed amendments to IFRS 4)

Comments to be received by 8 February 2016

Exposure Draft ED/2015/11 *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts* (Proposed amendments to IFRS 4) is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form. Comments need to be received by **8 February 2016** and should be submitted in writing to the address below, by email to commentletters@ifrs.org or electronically using our 'Comment on a proposal' page.

All comments will be on the public record and posted on our website unless the respondent requests confidentiality. Such requests will not normally be granted unless supported by good reason, for example, commercial confidence. Please see our website for details on this and how we use your personal data.

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Introduction

This Exposure Draft, published by the International Accounting Standards Board (IASB), contains proposed amendments to IFRS 4 *Insurance Contracts*. These amendments are designed to address the concerns of some interested parties about the different effective dates of IFRS 9 *Financial Instruments* and the forthcoming new insurance contracts Standard.

In July 2014, the IASB issued the completed version of IFRS 9. IFRS 9 sets out the requirements for recognising and measuring financial instruments. It replaces IAS 39 *Financial Instruments: Recognition and Measurement* and has an effective date of 1 January 2018 with early application permitted.

The IASB is also at an advanced stage in its project to replace IFRS 4 *Insurance Contracts*. However, the IASB expects to allow an implementation period of approximately three years after the publication of the new insurance contracts Standard. Hence, the earliest possible mandatory effective date of the new insurance contracts Standard will be after the effective date of IFRS 9.

Some interested parties, in particular insurers and their representative bodies, have suggested that the IASB should permit insurers to defer the application of IFRS 9 in order to align the effective date of IFRS 9 with the effective date of the new insurance contracts Standard (ie provide insurers with a temporary exemption from applying IFRS 9). They give the following reasons:

- (a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before the new insurance contracts Standard.
- (b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated.
- (c) Two sets of major accounting changes in a short period of time could result in significant cost and effort for both users and preparers of financial statements.

These concerns could be addressed, at least in part, without the need to amend existing Standards (for example, by using the existing accounting requirements of IFRS 4, the transition requirements in the new insurance contracts Standard and enhanced voluntary disclosures). However, some consider that without amending existing Standards it would be difficult to adequately address the concerns expressed about the different effective dates of IFRS 9 and the new insurance contracts Standard. Hence, the IASB proposes to introduce:

- (a) an option that would permit entities that issue contracts within the scope of IFRS 4 to reclassify, from profit or loss to other comprehensive income, some of the income or expenses arising from designated financial assets (the 'overlay approach'); and
- (b) an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4. This temporary exemption is targeted at entities that are most affected by the different effective dates of IFRS 9 and the new insurance contracts Standard, because they engage purely in activities that result in contracts within the scope of IFRS 4.

Having obtained approval from its Due Process Oversight Committee, the IASB has set a comment period for the Exposure Draft of 60 days. The IASB's *Due Process Handbook* permits a comment period on an Exposure Draft shorter than the standard minimum period of 120 days if the matter is narrow in scope and urgent. The IASB believes that the proposals in the Exposure Draft are both narrow in scope (because they only affect some entities that issue contracts within the scope of IFRS 4) and urgent (because any amendments to IFRS 4 resulting from these proposals need to be in place sufficiently in advance of the mandatory effective date of IFRS 9 for those affected by the proposals to implement them).

Next steps

The IASB will consider the comments that it receives on the proposals and will decide whether it will proceed with the proposed amendments to IFRS 4. The IASB intends to complete its redeliberations as soon as possible in 2016.

Invitation to comment

The IASB invites comments on the proposals in this Exposure Draft, particularly on the questions set out below. Comments are most helpful if they:

- (a) comment on the questions as stated;
- (b) indicate the specific paragraph(s) to which they relate;
- (c) contain a clear rationale; and
- (d) describe any alternative that the IASB should consider, if applicable.

The IASB is not requesting comments on matters in IFRS 4 that are not addressed in this Exposure Draft.

Comments should be submitted in writing so as to be received no later than 8 February 2016.

Questions for respondents

Question 1—Addressing the concerns raised
Paragraphs BC9–BC21 describe the following concerns raised by some interested parties about the different effective dates of IFRS 9 and the new insurance contracts Standard: (a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before the new insurance contracts Standard (paragraphs BC10–BC16). (b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated (paragraph BC17–BC18). (c) Two sets of major accounting changes in a short period of time could result in significant cost and effort for both preparers and users of financial statements (paragraphs BC19–BC21). The proposals in this Exposure Draft are designed to address these concerns. Do you agree that the IASB should seek to address these concerns? Why or why not?

Question 2—Proposing both an overlay approach and a temporary exemption from applying IFRS 9

The IASB proposes to address the concerns described in paragraphs BC9–BC21 by amending IFRS 4:

- (a) to permit entities that issue contracts within the scope of IFRS 4 to reclassify from profit or loss to other comprehensive income some of the income or expenses arising from designated financial assets that:
 - (i) are measured at fair value through profit or loss in their entirety applying IFRS 9 but
 - (ii) would not have been so measured applying IAS 39 (the ‘overlay approach’) (see paragraphs BC24–BC25);
- (b) to provide an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4 (the ‘temporary exemption from applying IFRS 9’) (see paragraphs BC26–BC31).

Do you agree that there should be both an overlay approach and a temporary exemption from applying IFRS 9? Why or why not?

If you consider that only one of the proposed amendments is needed, please explain which and why.

Question 3—The overlay approach

Paragraphs 35A–35F and BC32–BC53 describe the proposed overlay approach.

- (a) Paragraphs 35B and BC35–BC43 describe the assets to which the overlay approach can be applied. Do you agree that the assets described (and only those assets) should be eligible for the overlay approach? Why or why not? If not, what do you propose instead and why?
- (b) Paragraphs 35C and BC48–BC50 discuss presentation of amounts reclassified from profit or loss to other comprehensive income applying the overlay approach. Do you agree with the proposed approach to presentation? Why or why not? If not, what do you propose instead and why?
- (c) Do you have any further comments on the overlay approach?

Question 4—The temporary exemption from applying IFRS 9

As described in paragraphs 20A and BC58–BC60 the Exposure Draft proposes that only entities whose predominant activity is issuing contracts within the scope of IFRS 4 can qualify for the temporary exemption from applying IFRS 9.

- (a) Do you agree that eligibility for the temporary exemption from applying IFRS 9 should be based on whether the entity's predominant activity is issuing contracts within the scope of IFRS 4? Why or why not? If not, what do you propose instead and why?

As described in paragraphs 20C and BC62–BC66, the Exposure Draft proposes that an entity would determine whether its predominant activity is issuing contracts within the scope of IFRS 4 by comparing the carrying amount of its liabilities arising from contracts within the scope of IFRS 4 with the total carrying amount of its liabilities (including liabilities arising from contracts within the scope of IFRS 4).

- (b) Do you agree that an entity should assess its predominant activity in this way? Why or why not? If you believe predominance should be assessed differently, please describe the approach you would propose and why.

Paragraphs BC55–BC57 explain the IASB's proposal that an entity would assess the predominant activity of the reporting entity as a whole (ie assessment at the reporting entity level).

- (c) Do you agree with the proposal that an entity would assess its predominant activity at the reporting entity level? Why or why not? If not, what do you propose instead and why?

Question 5—Should the overlay approach and the temporary exemption from applying IFRS 9 be optional?

As explained in paragraphs BC78–BC81, the Exposure Draft proposes that both the overlay approach and the temporary exemption from applying IFRS 9 would be optional for entities that qualify. Consistently with this approach, paragraphs BC45 and BC76 explain that an entity would be permitted to stop applying those approaches before the new insurance contracts Standard is applied.

- (a) Do you agree with the proposal that the overlay approach and the temporary exemption from applying IFRS 9 should be optional? Why or why not?
- (b) Do you agree with the proposal to allow entities to stop applying the overlay approach or the temporary exemption from applying IFRS 9 from the beginning of any annual reporting period before the new insurance contracts Standards is applied? Why or why not?

Question 6—Expiry date for the temporary exemption from applying IFRS 9

Paragraphs 20A and BC77 propose that the temporary exemption from applying IFRS 9 should expire at the start of annual reporting periods beginning on or after 1 January 2021.

Do you agree that the temporary exemption should have an expiry date? Why or why not?

Do you agree with the proposed expiry date of annual reporting periods beginning on or after 1 January 2021? If not, what expiry date would you propose and why?

How to comment

Comments should be submitted using one of the following methods:

Electronically
(our preferred method) Visit the 'Comment on a proposal' page, which can be found at: go.ifrs.org/comment

Email Email comments can be sent to: commentletters@ifrs.org

Postal IFRS Foundation
30 Cannon Street
London EC4M 6XH
United Kingdom

All comments will be on the public record and posted on our website unless confidentiality is requested. Such requests will not normally be granted unless supported by good reason, for example, commercial confidence. Please see our website for details on this and how we use your personal data.

[Draft] Amendments to IFRS 4 *Insurance Contracts*

Paragraph 3 and the heading above paragraph 13 are amended. New headings are added below paragraphs 20, 35 and 37 and paragraphs 20A–20G, 35A–35F, 37A–37D and 41I–41K are added. Deleted text is struck through and new text is underlined.

Scope

- ...
- 3 This IFRS does not address other aspects of accounting by insurers, such as accounting for financial assets held by insurers and financial liabilities issued by insurers (see IAS 32 *Financial Instruments: Presentation*, IFRS 7 and IFRS 9 *Financial Instruments*), except;
- (a) [draft] paragraph 20A provides a temporary exemption from applying IFRS 9 to entities whose predominant activity is issuing contracts within the scope of this IFRS. If an entity elects to apply this temporary exemption, it shall apply IAS 39 *Financial Instruments: Recognition and Measurement*¹ rather than IFRS 9 and all references to IFRS 9 should be read as referring to IAS 39 (other than those in [draft] paragraphs 20A–20G, 35A–35F, 37A–37D and 41I–41K of this IFRS);
 - (b) [draft] paragraph 35A permits entities that issue contracts within the scope of this IFRS to apply the ‘overlay approach’ to qualifying financial assets; and
 - (c) in the transitional provisions described in paragraph 45.
- ...

Recognition and measurement

Temporary exemption from some other IFRSs applying IAS 8

...

Temporary exemption from applying IFRS 9 for some entities

- 20A An entity is permitted, but not required, to apply IAS 39 rather than IFRS 9 for annual reporting periods beginning before 1 January 2021 if and only if:**
- (a) it has not previously applied any version of IFRS 9², except as set out in paragraph 20B; and**

¹ References to IAS 39 in this [draft] IFRS are to the version of IAS 39 that does not reflect any amendments made by IFRS 9.

² The IASB issued successive versions of IFRS 9 in 2009, 2010, 2013 and 2014.

(b) its predominant activity is issuing contracts within the scope of this IFRS (see paragraph 20D).

20B An entity is permitted, but not required, to apply the temporary exemption from applying IFRS 9 described in [draft] paragraph 20A and, nonetheless, for annual reporting periods beginning before 1 January 2021, apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 of IFRS 9. Specifically, an entity meeting the requirements in paragraph 20A is permitted, but not required, to:

- (a) apply the temporary exemption from applying IFRS 9 if it has previously applied only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in IFRS 9; or
- (b) apply the temporary exemption from applying IFRS 9 and subsequently elect to apply only the requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in IFRS 9. Such entities shall disclose that fact, apply the relevant transition provisions in IFRS 9 and provide on an ongoing basis the related disclosures set out in paragraphs 10–11 of IFRS 7 (as amended by IFRS 9 (2010)).

20C An entity determines whether its predominant activity is issuing contracts within the scope of this IFRS based on the carrying amount of its liabilities arising from contracts within the scope of this IFRS relative to the total carrying amount of the entity's liabilities (including liabilities arising from contracts within the scope of this IFRS).

20D An entity shall initially assess whether its predominant activity is issuing contracts within the scope of this IFRS applying [draft] paragraph 20C on the date when the entity would otherwise be required to initially apply IFRS 9. At the end of subsequent annual reporting periods, the entity shall reassess whether its predominant activity is issuing contracts within the scope of this IFRS if and only if there is a demonstrable change in the corporate structure of the entity (for example, an acquisition or disposal of a business, that could result in a change in the predominant activity of the entity). If, as a result of a reassessment, an entity concludes that its predominant activity is no longer issuing contracts within the scope of this IFRS, the entity shall apply IFRS 9 from the beginning of its next annual reporting period.

20E An entity that previously elected to apply the temporary exemption from applying IFRS 9 described in [draft] paragraph 20A may at the beginning of any subsequent annual reporting period choose to apply IFRS 9 rather than IAS 39.

20F An entity that chooses or is required to stop applying the temporary exemption from applying IFRS 9 described in [draft] paragraph 20A shall, on initial application of IFRS 9, use the relevant transition requirements in that IFRS. Such entities are permitted, but not required, to apply the overlay approach described in [draft] paragraphs 35A–35F to qualifying financial assets.

20G If an entity elects to apply the temporary exemption from applying IFRS 9 described in [draft] paragraph 20A, all references to IFRS 9 should be read as referring to IAS 39 (other than those in [draft] paragraphs 20A–20G, 35A–35E, 37A–37D and 41I–41K of this IFRS).

...

Presentation

The overlay approach

35A **An entity that issues contracts within the scope of this IFRS and meets the criteria in [draft] paragraph 35B is permitted, but not required, to apply the ‘overlay approach’ to qualifying financial assets. An entity that applies the overlay approach shall reclassify from profit or loss to other comprehensive income an amount equal to the difference between:**

- (a) the amount reported in profit or loss for qualifying financial assets applying IFRS 9; and**
- (b) the amount that would have been reported in profit or loss for those qualifying financial assets applying IAS 39.**

35B A financial asset qualifies for the overlay approach if and only if the following criteria are met:

- (a) it is designated as relating to contracts that are within the scope of this IFRS; and
- (b) it is measured at fair value through profit or loss applying IFRS 9 but would not have been measured at fair value through profit or loss in its entirety applying IAS 39.

35C The amount reclassified from profit or loss to other comprehensive income shall be presented as a separate line item in the statement of profit or loss, other comprehensive income or both. The effect on individual line items in profit or loss of the amount reclassified from profit or loss to other comprehensive income shall be either presented on the face of the statement of profit or loss or disclosed in the notes to the financial statements.

35D 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 requirements for the presentation of gains and losses on financial liabilities designated as at fair value through profit or loss in paragraphs 5.7.1(c), 5.7.7–5.7.9, 7.2.14 and B5.7.5–B5.7.20 of IFRS 9. Otherwise, an entity that has previously applied any version of IFRS 9³ is prohibited from applying the overlay approach.

35E An entity that applies the overlay approach:

- (a) may newly designate a previously recognised financial asset as relating to contracts within the scope of this IFRS if and only if there is a change in the relationship between that financial asset and the contracts within the scope of this IFRS. For a financial asset newly designated as relating

³ The IASB issued successive versions of IFRS 9 in 2009, 2010, 2013 and 2014.

to contracts within the scope of this IFRS, its fair value at the date of designation shall be its new amortised cost carrying amount. The effective interest rate for such financial assets is determined based on their fair value at the date of designation.

- (b) shall de-designate a previously recognised financial asset as relating to contracts within the scope of this IFRS only when there is a change in the relationship between that financial asset and the contracts within the scope of this IFRS.
- (c) shall reclassify to profit or loss any balance accumulated in other comprehensive income relating to a previously designated financial asset if and when that financial asset no longer meets the qualifying criteria in [draft] paragraph 35B.
- (d) may, at the beginning of any annual reporting period, stop applying the overlay approach. An entity that stops applying the overlay approach shall apply IAS 8 to account for the change in accounting policy.

35F An entity that stops using the overlay approach because it chooses to do so applying [draft] paragraph 35E(d) or because it no longer issues contracts within the scope of this IFRS shall not subsequently apply the overlay approach. An entity that temporarily stops using the overlay approach because it no longer has qualifying financial assets (see paragraph 35B) may subsequently apply the overlay approach.

Disclosure

Explanation of recognised amounts

...

Disclosures about the temporary exemption from applying IFRS 9

37A If an entity applies the temporary exemption from applying IFRS 9 described in [draft] paragraph 20A, it shall disclose:

- (a) the fact that it is applying the temporary exemption from applying IFRS 9;
- (b) how the entity concluded that it is eligible for the temporary exemption from applying IFRS 9;
- (c) the fair value at the end of the reporting period and the fair value change during the reporting period of financial assets that would be measured at fair value through profit or loss applying IFRS 9 because they do not meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) of that IFRS; and
- (d) information about the credit risk exposure, including significant credit risk concentrations, inherent in financial assets that would meet the condition in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9 and are not held for trading or managed on a fair value basis applying that Standard. To enable users of financial statements to assess those risks, an entity shall disclose by credit risk rating grades the gross carrying amounts of those assets at the end of the reporting period.

37B If, applying [draft] paragraph 20D, an entity concludes that its predominant activity is no longer issuing contracts within the scope of this IFRS, it shall disclose in the annual reporting period in which it reached that conclusion:

- (a) the fact that it is no longer eligible to apply the temporary exemption from applying IFRS 9;
- (b) the reason why it is no longer eligible; and
- (c) the date on which the change in corporate structure occurred that made it ineligible.

Disclosures about the overlay approach

37C If, applying [draft] paragraphs 35A–35F of this IFRS, an entity reclassifies an amount from profit or loss to other comprehensive income, it shall 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.

37D To comply with [draft] paragraph 37C an entity shall disclose:

- (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 profit or loss to other comprehensive income 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 profit or loss to other comprehensive income 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 profit or loss to other comprehensive income 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 profit or loss in the reporting period arising from reclassifying any balance accumulated in other comprehensive income in respect of financial assets that have been de-designated (see [draft] paragraph 35E(c)).
- (e) the effect of the reclassification set out in [draft] paragraph 35A on each individual line item in the statement of profit or loss if this information is not presented on the face of the statement of profit or loss.

...

Effective date and transition

...

[for the temporary exemption only]

41I [Draft] Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Amendments to IFRS 4), issued in [date], amended paragraph 3 and the heading above paragraph 13 and added paragraphs 20A–20G and 37A–37B. An entity shall apply those amendments for annual periods beginning on or after 1 January 2018.

41J An entity that chooses to apply the temporary exemption from applying IFRS 9 described in paragraph 20A shall, when making the disclosures required by paragraphs 37A(c) and 37A(d), use the transition provisions in IFRS 9 that are relevant to making the assessments required for those disclosures. The date of initial application for that purpose shall be assumed to be the beginning of the first annual reporting period beginning on or after 1 January 2018.

...

[for the overlay approach only]

41K [Draft] Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Amendments to IFRS 4), issued in [date], amended paragraph 3 and the heading above paragraph 13 and added paragraphs 35A–35F and 37C–37D. An entity shall apply those amendments when it first applies IFRS 9 *Financial Instruments*. An entity that chooses to apply the overlay approach described in [draft] paragraph 35A shall:

- (a) apply that approach retrospectively to qualifying financial assets on transition to IFRS 9. Accordingly, the entity shall recognise as an adjustment to the opening balance accumulated in other comprehensive income an amount equal to the difference between the fair value of the qualifying financial assets determined applying IFRS 9 and their carrying amount determined applying IAS 39.
- (b) restate comparative information to reflect the overlay approach if and only if the entity restates comparative information in accordance with IFRS 9.

[Draft] Amendments to Appendix A—Defined terms

A new definition is added after the definition of ‘cedant’. New text is underlined.

...

Credit risk rating grades Rating of credit risk based on the risk of a default occurring on the financial instrument.

A new definition is added after the definition of ‘financial risk’. New text is underlined.

...

Gross carrying amount of a financial asset The amortised cost of a financial asset, before adjusting for any loss allowance.

A new definition is added after the definition of ‘guaranteed element’. New text is underlined.

...

Held for trading A financial asset or financial liability that:

- (a) is acquired or incurred principally for the purpose of selling or repurchasing in the near term;
- (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent pattern of short-term profit taking; or
- (c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedge instrument).

[Draft] amendments to other Standards

The IASB expects to make the amendments described below if it finalises the proposed amendments to IFRS 4.

Standard	Description of amendment
All IFRS	If the IASB finalises the proposed amendments to IFRS 4, it expects to indicate throughout IFRS that entities applying the temporary exemption from applying IFRS 9 in [draft] paragraphs 20A–20G, should apply IFRS without the amendments that would otherwise be made by Appendix C of IFRS 9 <i>Financial Instruments</i>.
IFRS 1 <i>First-time Adoption of International Financial Reporting Standards</i>	A heading and new paragraph is added to Appendix B of IFRS 1 as follows: ‘IFRS 4 Insurance Contracts A first-time adopter shall not apply the temporary exemption from applying IFRS 9 in [draft] paragraphs 20A–20G of IFRS 4 or the overlay approach in [draft] paragraphs 35A–35F of IFRS 4.’ Paragraph D4 of IFRS 1 is amended as follows (new text is underlined): ‘A first-time adopter may apply the transition provisions in <u>paragraphs 40–45 of IFRS 4 Insurance Contracts</u>. IFRS 4 restricts changes in accounting policies for insurance contracts, including changes made by a first-time adopter. <u>A first-time adopter shall not apply [draft] paragraphs 41I and 41K of IFRS 4.</u>’

Approval by the Board of *Applying IFRS 9* Financial Instruments *with IFRS 4* Insurance Contracts (Proposed amendments to IFRS 4) published in December 2015

The Exposure Draft *Applying IFRS 9* Financial Instruments *with IFRS 4* Insurance Contracts was approved for publication by eleven of the fourteen members of the International Accounting Standards Board. Mr Finnegan, Mr Mackintosh and Ms Tokar voted against its publication. Their alternative views are set out after the Basis for Conclusions on the Exposure Draft.

Hans Hoogervorst	Chairman
Ian Mackintosh	Vice-Chairman
Stephen Cooper	
Philippe Danjou	
Amaro Gomes	
Martin Edelmann	
Patrick Finnegan	
Gary Kabureck	
Suzanne Lloyd	
Takatsugu Ochi	
Darrel Scott	
Chungwoo Suh	
Mary Tokar	
Wei-Guo Zhang	

Basis for Conclusions on the Exposure Draft Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Proposed amendments to IFRS 4)

This Basis for Conclusions accompanies, but is not part of, the proposed amendments.

Background

- BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) when developing the amendments proposed in the Exposure Draft *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts*. Individual IASB members gave greater weight to some factors than to others.
- BC2 In July 2014, the IASB issued the completed version of IFRS 9. IFRS 9 sets out the requirements for recognising and measuring financial instruments. It replaces IAS 39 *Financial Instruments: Recognition and Measurement* and has an effective date of 1 January 2018 with early application permitted.
- BC3 The IASB also intends to replace IFRS 4 *Insurance Contracts*. The project to replace IFRS 4 is at an advanced stage. However, the IASB expects to allow a period of approximately three years after the publication of a new insurance contracts Standard for entities to implement that Standard. Hence, the earliest possible mandatory effective date of the new insurance contracts Standard will be after the effective date of IFRS 9.
- BC4 Some interested parties, in particular insurers and their representative bodies, have expressed concerns about the different effective dates of IFRS 9 and the new insurance contracts Standard. Some of those expressing these concerns have suggested that the IASB should permit insurers to defer the application of IFRS 9 in order to align the effective date of IFRS 9 with the effective date of the new insurance contracts Standard (ie provide insurers with a temporary exemption from applying IFRS 9).⁴
- BC5 In order to better understand the concerns expressed, IASB members and staff conducted a series of outreach meetings and calls with interested parties including insurers and their representative bodies and with users of financial statements. Having considered the feedback from these outreach meetings, the IASB decided to explore ways of addressing the concerns expressed about the different effective dates of IFRS 9 and the new insurance contracts Standard.
- BC6 The IASB is not proposing a temporary exemption from applying IFRS 9 for *all* insurers. This is because IFRS 9 introduces significant improvements in accounting for financial instruments that the IASB believes should be implemented on a timely basis. These improvements are particularly important for entities that issue insurance contracts, because they hold significant investments in financial instruments. The improvements introduced by IFRS 9 include:

⁴ For consistency with the existing terminology in IFRS 4, the Exposure Draft refers to a 'temporary exemption from applying IFRS 9' rather than a 'deferral of IFRS 9'.

- (a) the new, more forward looking expected credit loss impairment requirements and related disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*, which will better portray the credit quality of insurers' financial assets and provide better information about credit risk and how that risk is managed;
 - (b) classification and measurement requirements that will better portray how insurers manage their financial assets; and
 - (c) an improved hedge accounting model and associated disclosures about risk management.
- BC7 Rather than proposing a temporary exemption from applying IFRS 9 for *all* insurers the Exposure Draft proposes the following:
- (a) the introduction of an option for entities that issue contracts within the scope of IFRS 4 to reclassify from profit or loss to other comprehensive income (OCI) some of the income or expenses arising from designated financial assets (the 'overlay approach') (paragraphs BC24–BC25); and
 - (b) an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4 (paragraphs BC26–BC31).
- BC8 This Basis for Conclusions:
- (a) Describes the concerns raised about applying IFRS 9 before the new insurance contracts Standard is applied and how these concerns could be addressed, at least in part, by accounting treatments currently permitted by IFRS 4 and the transition provisions expected to be in the new insurance contracts Standard (paragraphs BC9–BC21).
 - (b) Describes different approaches to dealing with the concerns (paragraphs BC22–BC31).
 - (c) Describes the overlay approach (paragraphs BC32–BC53).
 - (d) Describes the temporary exemption from applying IFRS 9 for some entities that issue contracts within the scope of IFRS 4 (paragraphs BC54–BC77).
 - (e) Explains why the IASB is proposing that both the overlay approach and the temporary exemption should be optional (paragraphs BC78–BC81).
 - (f) Explains why the IASB is proposing to prohibit first-time adopters of IFRS from applying either the overlay approach or the temporary exemption from applying IFRS 9 (paragraph BC82).

Applying IFRS 9 with IFRS 4

- BC9 The concerns that have been expressed by some about the different effective dates of IFRS 9 and the new insurance contracts Standard can be summarised as follows:

- (a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before the new insurance contracts Standard (paragraphs BC10–BC16).
- (b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated (paragraph BC17–BC18).
- (c) Two sets of major accounting changes in a short period of time could result in significant cost and effort for both preparers and users of financial statements (paragraphs BC19–BC21).

Accounting mismatches and temporary volatility

- BC10 Currently IFRS 4 allows entities to apply a wide range of accounting policies for insurance contracts. However, the IASB understands that many entities measure insurance contracts on a cost basis and such entities measure many financial assets that relate to those insurance contracts at cost, amortised cost or fair value using the available-for-sale (AFS) category in IAS 39. If insurance contracts are measured on a cost basis and the related financial assets are measured at cost, amortised cost or fair value using the AFS category, then fewer accounting mismatches arise in profit or loss than if those financial assets are measured at fair value through profit or loss (FVPL).
- BC11 The classification of some financial assets may change on application of IFRS 9, and these changes may result in an increase in accounting mismatches in profit or loss. These changes may include the following:
- (a) Some debt instruments that are classified as AFS applying IAS 39 would be classified as FVPL in their entirety applying IFRS 9 because they would not meet the contractual cash flow characteristics test in paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9.
 - (b) An entity might choose not to apply the presentation election in IFRS 9 whereby fair value changes in investments in equity instruments are presented in other comprehensive income rather than in profit or loss. Many such equity investments would have been classified as AFS applying IAS 39.
- BC12 These additional accounting mismatches may be temporary. This is because the new insurance contracts Standard will require insurers to discount their insurance contracts using a current interest rate and the effect of changes in that interest rate can be reported in profit or loss. The income and expenses reported in profit or loss as a result of changes in current interest rates will offset, at least to some extent, the volatility in profit or loss arising from financial assets accounted for as FVPL.
- BC13 Some interested parties have also expressed concerns about the temporary volatility that would be reported in profit or loss that could arise from an insurer's interest in financial assets relating to participating contracts (usually called 'the shareholder's share'). For some entities, this volatility would only be

reported in profit or loss in the period between the application of IFRS 9 and application of the new insurance contracts Standard.

BC14 The IASB believes that the concerns about additional accounting mismatches and temporary volatility could be addressed, at least in part, by using the existing accounting requirements of IFRS 4. In particular, IFRS 4 permits the following:

- (a) Shadow accounting. Shadow accounting is a way of adjusting the aggregate carrying amount of insurance contracts to reduce accounting mismatches that can arise when unrealised gains and losses on assets held by the entity are recognised in the financial statements, but corresponding changes in the insurance contracts are not.
- (b) Use of current market interest rates. IFRS 4 permits insurers to use current market interest rates in the measurement of insurance contracts. If current market interest rates are used, the carrying amount of the insurance contract may be more responsive to changes in market conditions that also affect the fair value of the insurer's financial assets. As a result, the use of current market interest rates could reduce accounting mismatches.
- (c) Changes in accounting policy. IFRS 4 permits an entity to change its accounting policies for insurance contracts if the change makes the financial statements more relevant to the economic decision-making needs of users of financial statements and no less reliable, or more reliable and no less relevant to those needs. Thus, an entity applying IFRS 4 would be permitted to change its accounting policies for insurance contracts to reduce accounting mismatches, if those accounting mismatches do not provide a faithful representation of the underlying economic phenomena.

BC15 In addition, the IASB notes that many users of financial statements with whom the IASB discussed the issue of additional accounting mismatches and temporary volatility stated that such effects would not make their analysis more difficult. Those users stated that they already see volatility when analysing insurance entities and that they are able to make the adjustments necessary to understand the financial performance of such entities. In addition, some users stated that their analysis of insurance entities is primarily focussed on the statement of financial position rather than on profit or loss.

BC16 However, the IASB acknowledges that the existing requirements in IFRS 4 are unlikely to address all the concerns raised about additional accounting mismatches and temporary volatility. This is because:

- (a) The use of shadow accounting is limited to situations in which there is a direct relationship between the realisation of gains and losses on an insurer's assets and the measurement of its insurance contracts. Consequently, shadow accounting does not apply to contracts without participation features or to contracts for which there is only an indirect relationship between the insurance liability and the insurer's assets. In addition, shadow accounting does not apply to the shareholder's share. The IASB discussed whether to amend IFRS 4 to extend the use of shadow

accounting to non-participating contracts and to the shareholder's share. However, the IASB rejected this approach because it could potentially overcompensate for the consequences of applying IFRS 9.

- (b) Changing accounting policies to use current market interest rates shortly before the significant changes expected from the new insurance contracts Standard might place an additional burden on preparers. In addition, local regulation or regulatory requirements may prevent insurers in some jurisdictions from changing their accounting policies.

Applying IFRS 9 before a full evaluation of the effects of the new insurance contracts Standard

BC17 Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated. In particular, they have stated that the classification, designations and assessments made on initial application of IFRS 9 might not be the same as those that they would have made if they had initially applied the new insurance contracts Standard at the same time as IFRS 9. In addition, some have expressed concern that their business model for managing financial assets might be different at the time the new insurance contracts Standard is applied.

BC18 The IASB has acknowledged these concerns and intends to use the transition requirements of the new insurance contracts Standard to address them. In particular, those transition requirements will enable insurers to reassess particular aspects of the classification of their financial assets on application of the new insurance contracts Standard.

Two sets of accounting changes in a short period of time

BC19 Some interested parties are concerned that two sets of major accounting changes in a short period of time could result in significant cost and effort for preparers of financial statements and could make the financial statements less understandable for users.

BC20 However, the IASB is not aware of any evidence to support the notion that implementing the two Standards at different times would lead to significant additional costs compared to implementing them at the same time. In fact, some preparers, as well as some users of financial statements, have noted that two sets of changes may be easier to implement and understand than one major change. The IASB also notes that some users of financial statements have expressed the view that some of the concerns about applying two sets of accounting changes in a short period of time could be addressed by appropriate disclosures.

BC21 In addition, the IASB considers that for most entities, the advantages to users of financial statements of applying the improved accounting required by IFRS 9 on a timely basis outweigh the disadvantages of applying two sets of accounting changes in a short period of time.

Proposed amendments to IFRS 4 to address the concerns

- BC22 As discussed in paragraphs BC9–BC21 the existing accounting requirements in IFRS 4 and the transition requirements in the new insurance contracts Standard are unlikely to address all the concerns expressed about the different effective dates of IFRS 9 and IFRS 4. In particular:
- (a) they will not fully address the additional accounting mismatches and temporary volatility that could arise when IFRS 9 is applied before the new insurance contracts Standard; and
 - (b) they will not address the concerns raised by some interested parties about the cost and effort of applying two sets of accounting changes in a short period of time.
- BC23 The IASB therefore discussed the following approaches to address these concerns:
- (a) the overlay approach (paragraphs BC24–BC25); and
 - (b) a temporary exemption from applying IFRS 9 for entities that issue contracts within the scope of IFRS 4 (paragraphs BC26–BC31).

Overlay approach

- BC24 The IASB noted that additional accounting mismatches and temporary volatility that may arise when an entity applying IFRS 4 applies IFRS 9 could be addressed by amending IFRS 4 to permit entities to adjust pre-tax profit or loss to offset the effect of newly measuring financial assets at FVPL in their entirety (an ‘overlay approach’). The IASB noted that such an approach:
- (a) would ensure that the significant improvements in accounting for financial instruments introduced by IFRS 9 (described in paragraph BC6) would be implemented on a timely basis;
 - (b) would provide information about financial instruments that is comparable with the information that is provided by other entities that apply IFRS 9;
 - (c) ensures that all financial instruments within a reporting entity are consistently accounted for applying IFRS 9;
 - (d) would be effective in reducing accounting mismatches for participating and non-participating contracts and would eliminate the additional volatility in pre-tax profit or loss that may arise from applying IFRS 9; and
 - (e) would provide additional information to users of financial statements that would help them to understand the effects of IFRS 9, instead of resulting in less information being provided, as would be the case for a temporary exemption from applying IFRS 9.
- BC25 The IASB acknowledges that applying the overlay approach would require insurers to identify and track the financial assets that an entity newly measures at FVPL in their entirety applying IFRS 9. Thus, applying the overlay approach would require operational change. However, the IASB concluded that, compared

to other approaches, the advantages of the overlay approach for users of financial statements that are described in paragraph BC24 would outweigh any potential costs associated with the required operational change. In addition, the IASB noted that entities that would be permitted to apply the overlay approach would already have the systems required to measure the IAS 39 amounts for the eligible assets, would already have fair value information about those assets and will be required to develop systems to implement IFRS 9, irrespective of whether they choose to apply the overlay approach. Hence, the IASB concluded that the operational costs of the overlay approach would not be excessive and the Exposure Draft proposes this approach to reducing accounting mismatches and temporary accounting volatility in pre-tax profit or loss. Paragraphs BC32–BC53 discuss this approach in more detail.

Temporary exemption from applying IFRS 9 for insurers

- BC26 Although the overlay approach addresses the concerns raised about additional accounting mismatches and temporary volatility, it does not:
- (a) avoid the problems associated with insurers having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated; or
 - (b) avoid the need for insurers to apply two sets of major accounting changes in a short period of time.
- BC27 Consequently, as noted in paragraph BC4, some interested parties have suggested that the IASB should permit insurers to defer the application of IFRS 9 until the new insurance contracts Standard is applied (ie to provide a temporary exemption from applying IFRS 9). Such an approach would address most of the concerns raised by interested parties.
- BC28 However, the IASB noted that there are disadvantages to providing insurers with a temporary exemption from applying IFRS 9. In particular, such an approach would:
- (a) delay the application of IFRS 9 by insurers. As described in paragraph BC6, IFRS 9 introduces significant improvements in accounting for financial instruments and it is important that those improvements are implemented on a timely basis.
 - (b) create a different set of added costs and complexities for both preparers and users of financial statements by reducing comparability in the accounting for financial instruments. This lack of comparability would need to be mitigated by enhanced disclosures (for example, of the carrying amounts of financial assets as they would have been determined under IFRS 9), which would put an extra burden on preparers.
- BC29 The IASB also noted that the disadvantages of a temporary exemption from applying IFRS 9 would be more significant if, as some suggested, the exemption were to be provided below the reporting entity level (ie provide a temporary exemption for some but not all financial assets held by a reporting entity—see Appendix B). The IASB noted that providing an exemption below the reporting entity level would be likely to result in both IAS 39 and IFRS 9 being simultaneously applied by a single reporting entity. This would:

- (a) require new accounting guidance that could be complex and create operational challenges for preparers and confusion for users of financial statements; and
 - (b) create a risk of earnings management (for example, a reporting entity could choose either where to originate financial assets or where to transfer those assets to achieve a particular accounting outcome).
- BC30 The IASB concluded that for most entities the disadvantages of a temporary exemption from applying IFRS 9 would in most cases outweigh the advantages. Such entities could address any concerns about additional accounting mismatches and temporary volatility by electing to apply the overlay approach or by using the existing accounting requirements in IFRS 4 (see paragraphs BC9–BC21). Hence, the Exposure Draft does not propose a temporary exemption from applying IFRS 9 for *all* insurers.
- BC31 However, the IASB noted that for a small population of insurers (those whose predominant activity is issuing contracts within the scope of IFRS 4) the disadvantages of a temporary exemption from applying IFRS 9 would be less significant because the affected financial assets would represent a more significant proportion of the entity's assets. Also, by limiting the temporary exemption from applying IFRS 9 to a relatively small population of entities who are most affected by the different effective dates of IFRS 4 and IFRS 9, the problem of reduced comparability for users of financial statements would be reduced. Accordingly, the IASB decided to propose a temporary exemption from applying IFRS 9 for insurers whose predominant activity is issuing contracts within the scope of IFRS 4. Paragraphs BC54–BC77 discuss this approach in more detail.

Overlay approach

- BC32 As noted in paragraph BC11, additional accounting mismatches and temporary volatility may arise if IFRS 9 requires entities to classify financial assets as FVPL in their entirety that would not have been measured in that way applying IAS 39. The objective of the overlay approach is to address the additional accounting mismatches and temporary volatility by amending IFRS 4 to permit entities to adjust pre-tax profit or loss to offset the effects of IFRS 9 for these assets.
- BC33 Entities that apply the overlay approach are required to apply IFRS 9 in full. However, the incremental effect of measuring qualifying assets at FVPL rather than applying IAS 39 (after adjusting for the effects of applying shadow accounting) is removed from pre-tax profit or loss and reported in other comprehensive income.
- BC34 In developing this approach, the IASB discussed:
- (a) which assets would be eligible for the approach (paragraphs BC35–BC40);
 - (b) changes in eligibility and re-designation of financial assets (paragraphs BC41–BC43);

- (c) initial application and ceasing to apply the overlay approach (paragraphs BC44–BC46);
- (d) transition (paragraph BC47);
- (e) presentation (paragraphs BC48–BC50);
- (f) disclosures (paragraphs BC51–BC52); and
- (g) operational implications (paragraph BC53).

Eligibility for the overlay approach

- BC35 Consistently with the objective for the overlay approach described in paragraph BC32, the Exposure Draft proposes that financial assets that meet both of the following criteria should qualify for that approach:
- (a) financial assets that are classified at FVPL in their entirety applying IFRS 9 but that would not have been so measured applying IAS 39. Assets that are not measured at FVPL applying IFRS 9, and assets that are measured at FVPL in their entirety applying IAS 39, do not give rise to the new accounting mismatches or additional temporary volatility in profit or loss targeted by the overlay approach and would not qualify.
 - (b) financial assets that are designated as relating to contracts that are within the scope of IFRS 4 (see paragraphs BC36–BC40).
- BC36 The IASB considered restricting the application of the overlay approach to financial assets that are contractually linked to contracts within the scope of IFRS 4. However, the IASB noted that doing so would not meet the objective of the overlay approach. This is because the scope of the overlay approach would be very narrow—it would apply only to some types of participating contracts. Accordingly, instead of restricting the application of the overlay approach in this way, the Exposure Draft proposes that entities should be allowed to designate financial assets that relate to contracts within the scope of IFRS 4 and disclose the basis for identifying such financial assets.
- BC37 Although the overlay approach is intended to address additional accounting mismatches and temporary volatility in profit or loss arising from the application of IFRS 9 before the new insurance contracts Standard, the Exposure Draft does not propose to exclude from the overlay approach volatility that would continue under the new insurance contracts Standard. The IASB notes that, while it would have been preferable to address the concerns about the different effective dates of IFRS 9 and the new insurance contracts Standard in a more targeted way, an entity cannot be expected to know whether volatility is temporary without fully assessing the effect of the new insurance contracts Standard, which has not yet been published. The IASB also noted that minimising the number of criteria needed to apply the overlay approach makes the approach easier to understand and apply, which is particularly important given the temporary nature of the relief.
- BC38 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 to investment contracts that are outside of the scope of IFRS 4 would not qualify for the overlay approach.

- BC39 The IASB acknowledges 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 IASB noted that designated financial assets will be accounted for applying IFRS 9 and the proposed presentation and disclosure requirements will make the effect of the overlay approach transparent.
- BC40 The IASB considered, but rejected, requiring entities that elect to use the overlay approach to apply it to *all* eligible financial assets. The IASB 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 in reducing volatility in profit or loss.

Changes in eligibility and re-designation of financial assets

- BC41 Consistently with the IASB's objective for the overlay approach, the Exposure Draft proposes that:
- (a) an entity can elect to apply the overlay approach on a prospective basis to new or existing financial assets when the qualifying criteria for the overlay approach are met; and
 - (b) the overlay approach should not be applied to any financial assets for which the qualifying criteria are no longer met (for example, an asset that is transferred from an insurance business segment to a non-insurance business segment).
- BC42 To address concerns about the potential for entities to change the designation of their financial assets to achieve a particular accounting outcome, the Exposure Draft proposes that entities should be permitted to change the designation of a financial asset only if there is a change in the relationship between the financial asset and the contracts within the scope of IFRS 4 (for example, an asset is transferred between an insurance business segment and a non-insurance business segment).
- BC43 The IASB noted that, because of the way in which the amount reclassified from profit or loss to OCI is calculated (see paragraph 35A), the cumulative amount reported in OCI usually aggregates to zero when a designated financial asset is derecognised. Hence, reclassifying (recycling) amounts accumulated in OCI on derecognition of a financial asset is generally unnecessary. However, the cumulative amount reported in OCI does not aggregate to zero if a financial asset no longer qualifies for the overlay approach. The Exposure Draft proposes that any balance accumulated in OCI relating to financial assets that no longer qualify for the overlay approach should be immediately recycled to profit or loss. This is to ensure that the effect on profit or loss of a financial asset that no longer qualifies for the overlay approach is the same as for a financial asset that is derecognised. The IASB notes that requiring recycling when the financial

asset no longer qualifies for the overlay approach is simpler than tracking all such financial assets and requiring recycling when the financial asset is derecognised.

Initial application of and ceasing to apply the overlay approach

BC44 Because the overlay approach is designed to deal with additional accounting mismatches and temporary volatility in profit or loss that could arise when entities apply IFRS 9 before they apply the new insurance contracts Standard, the Exposure Draft proposes that:

- (a) 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.
- (b) an entity that has already applied IFRS 9 without applying the overlay approach would not be permitted to start applying the overlay approach. Such entities will already have had to explain the effects of applying IFRS 9 to the users of their financial statements. However, because the overlay approach affects only financial assets, it is proposed that entities that elect (or have elected) to apply only the 'own credit' requirements in IFRS 9 for financial liabilities would still be permitted to apply the overlay approach.
- (c) the overlay approach will no longer be permitted when a reporting entity first applies the new insurance contracts Standard, which will supersede IFRS 4.

BC45 The Exposure Draft proposes that an entity can stop using the overlay approach at the beginning of any annual reporting period. This reflects the IASB's view that entities should not be prevented from reporting their financial performance without the adjustment required by the overlay approach.

BC46 The Exposure Draft proposes that an entity that chooses to stop using the overlay approach or no longer issues contracts within the scope of IFRS 4 would not subsequently be permitted to use the overlay approach. 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. Entities that temporarily stop using the overlay approach because they no longer have qualifying financial assets would, however, subsequently be permitted to apply the overlay approach.

Transition

BC47 Because an entity that applies the overlay approach also applies IFRS 9, the Exposure Draft proposes that when an entity first applies the overlay approach to its financial assets the approach to transition and comparatives for the overlay approach should be consistent with the approach to transition and comparatives taken in IFRS 9. IFRS 9 requires entities to apply that Standard retrospectively, subject to some transition reliefs. It also permits an entity to restate comparative information on transition to IFRS 9 except in some cases in which restating comparatives is prohibited. Consequently, the IASB proposes that an entity would be required to restate comparative information to reflect

the overlay approach only when the entity restates comparative information on transition to IFRS 9. The Exposure Draft proposes that the entity would be prohibited from applying the overlay approach to the comparative information when comparative information for financial assets is not restated on transition to IFRS 9.

Presentation in the overlay approach

- BC48 The overlay approach results in the presentation of IFRS 9 information in the statements of financial position and comprehensive income and therefore enables users of financial statements to compare those entities who apply the overlay approach with those that do not. To help with this comparison, the Exposure Draft proposes that entities that apply the overlay approach should present the amount reclassified from profit or loss to OCI as a separate line item in the statement of profit or loss, OCI or both. This should enable users of financial statements to calculate what profit or loss before tax would have been without the overlay adjustment and consequently to compare profit or loss before tax on a consistent basis regardless of whether the entity applies the overlay approach.
- BC49 The IASB considered requiring an entity to explain the effect of the overlay approach 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 IASB noted that the general principle in IAS 1 *Presentation of Financial Statements* 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 a profit or loss subtotal determined applying IFRS 9, would restrict the presentation formats that would be available. Similarly, requiring an explanation of the effect of the overlay approach on each relevant line item on the face of the statement of profit or loss would restrict an entity from making a judgement as to whether such presentation would be useful. Accordingly, the Exposure Draft proposes that there should not be a requirement for an entity to present the effects of the overlay approach as a single line item in profit or loss, or to explain those effects on relevant line items on the face of the statement of profit or loss. Similarly, the Exposure Draft does not propose to prohibit entities from presenting additional line items, headings and sub-totals in the statement of comprehensive income.
- BC50 However, the IASB proposes that 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 presented on the face of the statement of profit or loss.

Disclosures

- BC51 To enable comparisons to be made between those entities that apply the overlay approach and those that do not, the Exposure Draft proposes disclosures that enable users of the financial statements to understand the effect of the overlay approach on the financial statements.

- BC52 The Exposure Draft proposes general disclosure principles that will enable entities to determine the most appropriate disclosures. However, to address the concerns expressed by some that changes in designation of financial assets could be used to manipulate reported profit, the Exposure Draft also proposes specific disclosure requirements for changes in designation of financial assets.

Operational implications

- BC53 The IASB acknowledges that applying the overlay approach would be more costly than applying only IFRS 9. This is because amortised cost and ‘incurred loss’ impairment information is needed to measure the designated financial assets applying IAS 39. In addition, when the measurement of the insurance contract incorporates shadow accounting adjustments, an entity may need to determine those shadow accounting adjustments when assets are measured applying IAS 39 as well as applying IFRS 9. However:
- (a) the IASB proposes that the overlay approach should be optional. Therefore, if the cost of continuing to apply IAS 39 to designated financial assets is excessive, an entity could choose not to apply the overlay approach and instead explain the additional accounting mismatches and temporary volatility to its investors; and
 - (b) the overlay approach would only apply if the entity was already measuring the financial assets applying IAS 39 other than at FVPL in their entirety. Consequently, the entity will already have a system in place for determining cost or amortised cost (including any impairment) of such assets. In addition, because IAS 39 requires disclosure of the fair value of most financial assets, the entity will have fair value information about most of the assets to which it will apply the overlay approach. Thus the overlay approach would not be more costly to apply compared to applying IAS 39.

Temporary exemption from applying IFRS 9 for some insurers

- BC54 As explained in paragraph BC31, the IASB has decided not to propose a temporary exemption from applying IFRS 9 for all insurers. Instead, the IASB proposes a temporary exemption from applying IFRS 9 only for some entities that are affected by the different effective dates of IFRS 9 and the new insurance contracts Standard because their predominant activity is to issue contracts within the scope of IFRS 4.
- BC55 The IASB identified two ways in which eligibility for the temporary exemption from applying IFRS 9 could be assessed:
- (a) Assessment at the reporting entity level. Under this alternative, an entity that issues contracts within the scope of IFRS 4 would assess whether the entity as a whole qualifies for the temporary exemption. This means that such a reporting entity would apply only one Standard for accounting for financial instruments—IFRS 9 or IAS 39. Appendix A illustrates assessment at the reporting entity level.

- (b) Assessment below the reporting entity level. Under this alternative, a reporting entity that issues contracts within the scope of IFRS 4 would assess whether it qualifies for the temporary exemption below the reporting entity level. This means that such a reporting entity would simultaneously apply two Standards for accounting for financial instruments—IFRS 9 and IAS 39. Appendix B describes how the temporary exemption might work if it were applied below the reporting entity level.
- BC56 The Exposure Draft proposes that entities should assess whether they are eligible for the temporary exemption from applying IFRS 9 at the reporting entity level rather than below the reporting entity level. This is because assessment at the reporting entity level:
- (a) is easier for users to understand because it does not result in the simultaneous application of IFRS 9 and IAS 39 by the same reporting entity.
 - (b) captures a relatively narrow population of entities and, therefore, maximises the number of entities required to apply the improved accounting required by IFRS 9.
 - (c) is simpler for preparers to apply and users to understand because it avoids the need for accounting requirements for transfers of financial instruments between those parts of a reporting entity that qualify for the temporary exemption from applying IFRS 9 and those that do not.
- BC57 In addition, the IASB noted that many users of financial statements who participated in outreach conducted by the IASB:
- (a) did not support a temporary exemption below the reporting entity level; and
 - (b) expressed concerns about the earnings management opportunities that could arise if eligibility for the temporary exemption is assessed below the reporting entity level. In particular, they noted that income and expenses could arise on transfers of financial assets between those parts of a reporting entity that qualify for the temporary exemption from applying IFRS 9 and those that do not.
- BC58 In determining which reporting entities should be permitted to apply the temporary exemption from applying IFRS 9, the IASB placed more weight on ensuring that the temporary exemption could not be applied by entities that have non-insurance activities (for example, entities with banking activities) than on ensuring that all insurance-related assets are included within the scope of the temporary exemption. This is because the temporary exemption defers the application of the improved accounting requirements of IFRS 9, in particular the more forward-looking expected credit loss impairment model, and results in reduced comparability between entities holding financial instruments.
- BC59 Hence, the Exposure Draft proposes that the temporary exemption from applying IFRS 9 should only be available to entities whose predominant activity is issuing contracts within the scope of IFRS 4. As a result:

- (a) Entities that issue contracts within the scope of IFRS 4 but for which this activity is not predominant would not qualify for the temporary exemption (and, therefore, would apply IFRS 9).
- (b) Although some financial instruments that relate to non-insurance activities will inevitably be included within the scope of the temporary exemption, such financial assets are minimised.

BC60 The IASB acknowledges that assessing eligibility for the temporary exemption from applying IFRS 9 at the reporting entity level on the basis of predominant activities would only capture a relatively narrow population of entities and would therefore not address the concerns about different effective dates of IFRS 9 and the new insurance contracts Standard for all insurers. However, the IASB believes that for most entities the overlay approach described in paragraphs BC32–BC53 more appropriately addresses the effects of additional temporary volatility and can be used by those entities that do not qualify for, or choose not to apply, the temporary exemption. The IASB also believes that the proposed approach to assessing eligibility for the temporary exemption better balances the needs of preparers and users of financial statements by addressing the key concerns of preparers without reducing the information provided to users.

BC61 In developing the proposed temporary exemption from applying IFRS 9, the IASB discussed:

- (a) how to describe predominance (paragraphs BC62–BC66);
- (b) initial assessment and reassessment of predominance (paragraphs BC67–BC69);
- (c) disclosure (paragraphs BC70–BC72);
- (d) transition (paragraphs BC73–BC76); and
- (e) whether to set an expiry date for the temporary exemption (paragraph BC77).

Describing predominance

BC62 The Exposure Draft proposes that an entity would determine whether its predominant activity is issuing contracts within the scope of IFRS 4 by comparing the carrying amount of its liabilities arising from contracts within the scope of IFRS 4 with the total carrying amount of its liabilities (including any liabilities arising from contracts within the scope of IFRS 4).

BC63 The IASB decided to describe predominance by reference to an entity's liabilities, rather than by reference to its income and expenses, because:

- (a) If predominance were described by reference to income and expenses, the IASB would need to decide whether the description should be based on gross insurance income relative to total income, or whether it should be based on net insurance income relative to total net income. However, a similar question does not arise if the description of predominance is based on the statement of financial position.

- (b) The IASB thinks that the statement of financial position provides a more stable basis for assessing predominance than the statement of comprehensive income. This is because amounts reported in the statement of financial performance of insurers can be volatile.
- BC64 The IASB also considered whether predominance should be described by comparing an entity's liabilities arising from contracts within the scope of IFRS 4 to the aggregate carrying amount of its liabilities and shareholders' equity. However, the IASB decided that predominance should be described by comparing an entity's liabilities arising from contracts within the scope of IFRS 4 to the total carrying amount of its liabilities. This is because the carrying amount of shareholders' equity does not necessarily reflect the nature of an entity's activities. In contrast, many of an entity's liabilities directly reflect the nature of an entity's activities. For example, if an entity engages in banking activities many of its liabilities will be deposits from customers. The IASB acknowledges that other types of liability (for example, tax liabilities or pension liabilities) could also affect the ratio of liabilities arising from contracts within the scope of IFRS 4 to total liabilities. However, the IASB note that the approach proposed in the Exposure Draft is simpler to apply than any approach that would adjust for liabilities arising from, for example, taxation or pensions and would encompass most situations in which an entity's predominant activity is to issue contracts within the scope of IFRS 4.
- BC65 The IASB noted that specifying a particular quantitative threshold for when insurance activities would be considered predominant would be arbitrary. Consequently, the Exposure Draft does not propose a quantitative threshold for predominance. However, the IASB notes that the temporary exemption from applying IFRS 9 is targeted at the entities that are most significantly affected by the different effective dates of IFRS 9 and the new insurance contracts Standard, because they engage purely in activities that result in contracts within the scope of IFRS 4. It is not designed to apply to entities that engage in activities other than issuing contracts within the scope of IFRS 4, for example, banking or asset management activities. Accordingly, 'predominance' is intended to be a high threshold. For example, if three-quarters of an entity's liabilities are liabilities arising from contracts within the scope of IFRS 4 and one-quarter are liabilities arising from other activities, that entity would not, for the purposes of the Exposure Draft, meet the predominance condition.
- BC66 The IASB discussed requiring entities to consider all relevant facts and circumstances when assessing whether insurance activities are predominant for an entity, rather than a simple comparison of liabilities arising from contracts within the scope of IFRS 4 to total liabilities. For example, the entity could be required to consider, among other things, the composition of its liabilities, the composition of its income and expenses and whether it is regulated as an insurer. The IASB rejected this approach as too complex, because under this approach an entity would need to consider several factors to determine whether it qualifies for the temporary exemption rather than a single factor. The IASB also noted that many users of financial statements called for a simple and transparent approach to assess eligibility for the temporary exemption.

Initial assessment and reassessment of predominance

- BC67 The Exposure Draft proposes that an entity should determine whether its predominant activity is issuing contracts within the scope of IFRS 4 at the point in time when it would otherwise be required to initially apply IFRS 9 (at the beginning of the first annual reporting period beginning on or after 1 January 2018). This proposal reflects the IASB's view that an entity's previous activities or future intentions are not relevant for determining eligibility for the temporary exemption from applying IFRS 9.
- BC68 The Exposure Draft also proposes that an entity should be required to reassess at the end of its subsequent annual reporting periods whether its predominant activity is issuing contracts within the scope of IFRS 4 only if there has been a demonstrable change in the structure of the entity (for example, the acquisition or disposal of a business). The Exposure Draft proposes not to permit or require an entity to perform a reassessment if there is merely a change in the level of insurance liabilities relative to total liabilities. This is because such a change, in the absence of other events, would be unlikely to indicate a change in the predominant activities of the entity.
- BC69 The Exposure Draft proposes that if a reassessment following a change in structure indicates that the predominance condition is no longer met, the entity would be required to apply IFRS 9 from the beginning of the *next* annual reporting period. For example, if an entity concludes on 31 December 2019 (the end of its annual reporting period) that its predominant activity is no longer issuing contracts within the scope of IFRS 4 because it acquired a bank during 2019 then the entity would apply IFRS 9 from 1 January 2020 (ie the beginning of its next annual reporting period). The Exposure Draft proposes disclosures in the period that the reassessment took place (in the example above, the period ending 31 December 2019) to enable users of financial statements to understand that the entity will no longer be eligible for the temporary exemption from applying IFRS 9 in the next annual reporting period. The IASB notes that the proposed approach to reassessment could result in some entities that become ineligible for the temporary exemption early in an annual reporting period nevertheless applying IAS 39 throughout that annual reporting period. However, the IASB believes that the proposed disclosure requirements for entities applying the temporary exemption should mitigate this concern. In addition, the IASB does not expect changes in the structure of entities applying the temporary exemption to occur frequently and notes that the temporary exemption is intended to apply only in the short-term.

Disclosure

- BC70 Many users of financial statements have expressed concerns that a temporary exemption from applying IFRS 9 will make cross-sector comparisons more difficult. In addition, the fact that the temporary exemption is optional will reduce comparability within the insurance sector.
- BC71 To address these concerns, the Exposure Draft proposes disclosure requirements in paragraphs 37A–37B that would enable users of financial statements to make comparisons between entities that apply the temporary exemption from applying IFRS 9 and other entities. These disclosures are similar to some of the

disclosures required to be provided by entities applying IFRS 9, but primarily rely on an assessment of the contractual terms of the financial assets. They are intended to reduce the need for an entity to assess the business model for financial assets prior to the application of the new insurance contracts Standard and IFRS 9.

- BC72 The IASB considered requiring entities that apply the temporary exemption from applying IFRS 9 to reconcile the information provided in the financial statements with the information that would have been provided if the entity had instead applied IFRS 9. The IASB noted that requiring such a reconciliation would better enable users of financial statements to compare entities applying the temporary exemption with those that do not. However, the IASB rejected this approach because of the costs it would impose on preparers, noting that this would reduce the potential benefits to preparers of the temporary exemption. The IASB noted that if the population of entities to which the temporary exemption applied were broader or the temporary exemption were to apply for a longer period, then more detailed disclosures (including a reconciliation to IFRS 9) would be needed to mitigate the effects of reduced comparability.

Transition

- BC73 The IASB thinks that an entity that has already applied IFRS 9 (other than only the 'own credit' requirements in IFRS 9), should not be permitted to stop applying IFRS 9 and start applying IAS 39 because:
- (a) doing so would mean an entity no longer provided the improved information about financial instruments required by IFRS 9;
 - (b) doing so would disrupt trend information several times (ie on transition to IFRS 9, followed by transition back into IAS 39, followed by a second transition to IFRS 9 when the entity applies the new insurance contracts Standard); and
 - (c) if an entity has already applied any version of IFRS 9 (other than the 'own credit' requirements), it will have already explained the effects of any additional temporary volatility to users of financial statements and incurred the related costs of first-time application.
- BC74 Consequently, the Exposure Draft proposes that an entity:
- (a) should be permitted to start applying the temporary exemption from applying IFRS 9 only at the time it would otherwise have been required to start applying IFRS 9; and
 - (b) should not be permitted to stop applying IFRS 9 and revert to applying IAS 39.
- BC75 The IASB noted that when an entity first applies the temporary exemption, no special transition provisions are needed. The entity would continue applying IAS 39 and start providing the additional relevant disclosures proposed by the Exposure Draft, applying the transition requirements in IFRS 9 to the extent needed for those disclosures.
- BC76 The IASB thinks that an entity that applies the temporary exemption should be permitted to stop doing so and start applying IFRS 9 from the beginning of any

annual reporting period. At that point, an entity would apply the transition requirements in IFRS 9 in the usual way and stop providing the disclosures required by the Exposure Draft relating to the temporary exemption. The Exposure Draft proposes that such entities could choose to apply the overlay approach when they first apply IFRS 9 until the new insurance contracts Standard is applied.

Expiry date for the temporary exemption

- BC77 The Exposure Draft proposes that entities should be prohibited from applying the temporary exemption from applying IFRS 9 for annual reporting periods beginning on or after 1 January 2021. The IASB believes that, even if the new insurance contracts Standard is not effective by that date, all entities should apply IFRS 9 by that date. This is because IFRS 9 represents a significant improvement to the accounting requirements for financial instruments. Hence, a temporary exemption from applying IFRS 9 is only acceptable if the period between the effective dates of IFRS 9 and the new insurance contracts Standard is short.

Should the overlay approach and the temporary exemption from applying IFRS 9 be optional?

- BC78 Most users of financial statements that participated in the outreach conducted by the IASB stated that any approach proposed to address the concerns about applying IFRS 9 before the new insurance contracts Standard should be mandatory rather than optional to ensure comparability at least within the insurance sector, even if cross-sector comparability is not achieved.
- BC79 However, the Exposure Draft proposes that both the overlay approach and the temporary exemption from applying IFRS 9 should be optional rather than mandatory. This is because the IASB believes that entities should not be prevented from reporting their profit or loss and other comprehensive income applying the improved accounting requirements of IFRS 9 without adjustment if they wish to do so. In addition, for some entities, the problems associated with additional accounting mismatches and temporary volatility do not arise because, for example, they use a current interest rate to discount their insurance contracts. The IASB also noted that in some jurisdictions, regulators could decide not to permit the use of the temporary exemption from applying IFRS 9.
- BC80 In addition, the IASB believes that:
- (a) the overlay approach should be optional because it is more operationally complex than applying IFRS 9 without adjustment (see paragraph BC53). Some entities could better meet the needs of users of financial statements by explaining the effect of IFRS 9 on their financial statements.
 - (b) any temporary exemption from applying IFRS 9 should be optional, because it would not be appropriate to require entities that issue contracts within the scope of IFRS 4 to apply that temporary exemption, if:

- (i) they could better meet the needs of users of financial statements by explaining the effect of IFRS 9 on their financial statements.
 - (ii) entities have already implemented, or have started implementing, IFRS 9. Requiring such entities to apply the temporary exemption from applying IFRS 9 would mean that these implementation efforts could be wasted.
- BC81 The IASB acknowledges that making the overlay approach and the temporary exemption optional could reduce comparability between entities. However, the IASB expects that this concern would be mitigated by the disclosure requirements proposed in the Exposure Draft. In addition, the IASB expects that any reduction in comparability would only exist for a short period of time (ie until the new insurance contracts Standard is applied or the temporary exemption expires).

First-time adopters of IFRS

- BC82 The Exposure Draft proposes that first-time adopters of IFRS should be prohibited from applying the overlay approach and the temporary exemption from applying IFRS 9 because:
- (a) such an approach is consistent with the concepts underlying IFRS 1 *First-time Adoption of International Financial Reporting Standards* which, in general, require entities to apply the current version of IFRS—in this case, IFRS 9;
 - (b) first-time adopters could avoid any additional accounting mismatches or temporary volatility by adopting the new insurance contracts Standard early or by adopting accounting policies that are consistent with the new insurance contracts Standard; and
 - (c) the overlay approach and the temporary exemption from applying IFRS 9 are intended to address concerns raised about the temporary accounting consequences that could arise when an entity makes the transition from IAS 39 to IFRS 9 on a different date from when the entity first applies the new insurance contracts Standard. However, first-time adopters will be making the transition from previous national financial reporting requirements to IFRS 9, rather than from IAS 39 to IFRS 9.

Alternative views

Alternative views on the Exposure Draft *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts* (Proposed amendments to IFRS 4) as published in December 2015

- AV1 Mr Finnegan, Mr Mackintosh and Ms Tokar voted against the publication of the Exposure Draft because they disagree with the proposal to provide entities whose predominant activity is issuing contracts within the scope of IFRS 4 *Insurance Contracts* with a temporary exemption from applying IFRS 9 *Financial Instruments*. They believe that it is important for IFRS 9 to be adopted on a timely basis because of the significant improvements that IFRS 9 requires in accounting for financial assets, including a new impairment model that is based on expected credit losses and related enhanced disclosures about credit risk. They note that these improvements were made in response to calls from regulators, and users of financial statements following the global financial crisis and that regulators and users have called for these improvements to be introduced without delay. They also note that the proposed temporary exemption from applying IFRS 9 will reduce comparability between reporting entities, including between entities that issue insurance contracts.
- AV2 Mr Finnegan, Mr Mackintosh and Ms Tokar acknowledge the concerns discussed in paragraphs BC9–BC21 about the different effective dates of IFRS 9 and the forthcoming new insurance contracts Standard. In particular, they agree that the classification and measurement requirements of IFRS 9 may lead to new accounting mismatches and, hence, an increase in reported volatility within profit or loss for those entities that measure insurance contracts on a cost basis. They also note that some of that volatility is expected to be offset in net profit or loss when the new insurance contracts Standard is applied because that new Standard is expected to require entities to measure insurance contracts at current estimates of fulfilment cash flows discounted at a current rate.
- AV3 Ms Tokar also objects to the characterisation of all of the additional volatility resulting from applying IFRS 9 without the new insurance contracts Standard as ‘temporary’. She notes that this is true only to the extent that this volatility will be offset by remeasurement of the insurance liability when the new insurance contracts Standard is applied and insurance contract liabilities are measured using a current discount rate.
- AV4 Mr Finnegan, Mr Mackintosh and Ms Tokar believe that the proposal to permit entities that issue contracts within the scope of IFRS 4 to reclassify some of the income or expenses arising from designated financial assets from profit or loss to other comprehensive income (the ‘overlay approach’) makes a temporary exemption from applying IFRS 9 unnecessary. They note that the overlay approach deals more appropriately with the concerns expressed about additional accounting mismatches and temporary volatility because:

- (a) it provides users of financial statements with the benefits of the improved accounting required by IFRS 9 but also removes from profit or loss the effect of recognising more volatility until measurement of insurance contracts is aligned more closely with measurement of related assets; and
- (b) it permits users of financial statements to compare entities that issue insurance contracts and apply the overlay approach with those that do not, and with other entities that hold similar financial assets. This comparability will be lost if entities are permitted a temporary exemption from applying IFRS 9.

AV5 Mr Finnegan and Ms Tokar note that the transparency and usefulness of the overlay approach would be enhanced if the IASB required the overlay adjustment reported within profit or loss to be presented separately from the effects of applying IFRS 9.

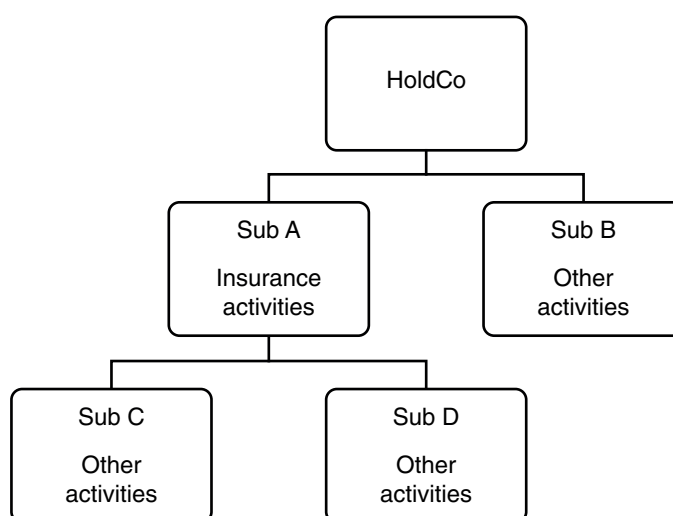
AV6 Mr Finnegan, Mr Mackintosh and Ms Tokar also note that if the proposals in the Exposure Draft become effective, three different reporting outcomes would be created for entities that issue insurance contracts: (a) application of IFRS 9 without the overlay approach; (b) application of IFRS 9 with the overlay approach; and (c) use of the temporary exemption from applying IFRS 9. They believe that this could significantly reduce comparability between entities that issue insurance contracts and between entities applying the temporary exemption from applying IFRS 9 and those that do not and hold similar financial assets.

AV7 Mr Finnegan and Mr Mackintosh disagree with the proposal in the Exposure Draft to set an expiry date for the temporary exemption from applying IFRS 9 because they believe that it is unlikely to be effective in restricting the period during which the temporary exemption is available for use. They are concerned that further delays in finalisation of the new insurance contracts Standard could result in the temporary exemption being in place longer than the three years proposed in the Exposure Draft.

Appendix A—Assessing predominance at the reporting entity level

A1 The Exposure Draft proposes that entities should assess whether they are eligible for the temporary exemption from applying IFRS 9 at the reporting entity level. The IASB's reasons for proposing this approach are discussed in paragraphs BC56–BC58. This appendix illustrates how assessment at the reporting entity level is performed.

A2 The following group structure is used to illustrate the approach:



A3 If issuing contracts within the scope of IFRS 4 is the predominant activity of the group as a whole, HoldCo would be eligible for the temporary exemption from applying IFRS 9 and could apply IAS 39 in its consolidated financial statements. However, that would not affect the accounting in the separate financial statements of Subsidiaries A, B, C and D.

A4 For example, if issuing contracts within the scope of IFRS 4 is *not* the predominant activity of Subsidiary B, it would be required to apply IFRS 9 in its separate financial statements. However, on consolidation, if the temporary exemption is applied, HoldCo would reverse the effect of application of IFRS 9 by Subsidiary B for inclusion in HoldCo's consolidated financial statements.

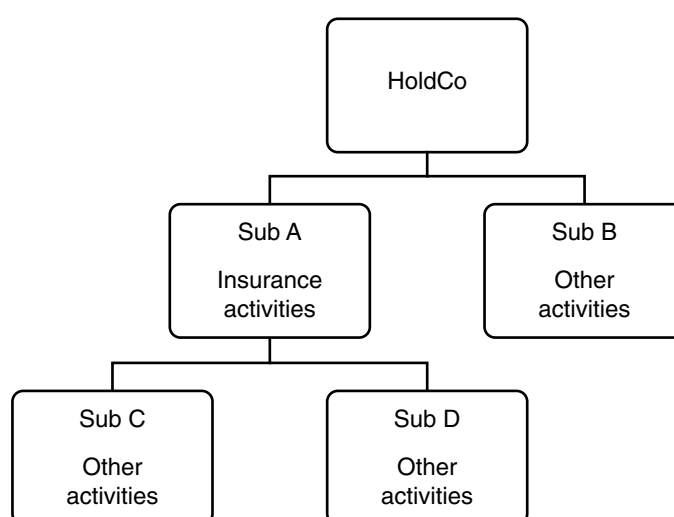
A5 If issuing contracts within the scope of IFRS 4 is not the predominant activity of the group as a whole, HoldCo would not be eligible for the temporary exemption and would be required to apply IFRS 9 to all financial instruments in its consolidated financial statements. However, that would not affect the accounting in the separate financial statements of Subsidiaries A, B, C and D.

A6 For example, if Subsidiary A issues its own consolidated financial statements (ie consolidating Subsidiaries C and D) and issuing contracts within the scope of IFRS 4 is the predominant activity for that sub-group, Subsidiary A would be

eligible for the temporary exemption from applying IFRS 9 in its consolidated financial statements. However, if Subsidiary A applies the temporary exemption, on consolidation, HoldCo would have to reverse the effect of application of IAS 39 by Subsidiary A and apply IFRS 9 for inclusion in HoldCo's consolidated financial statements.

Appendix B—Assessing predominance below the reporting entity level

- B1 The Exposure Draft proposes that entities should assess whether they are eligible for the temporary exemption from applying IFRS 9 at the reporting entity level. The IASB's reasons for proposing this approach are discussed in paragraphs BC56–BC58.
- B2 This appendix explains some of the considerations that led the IASB to reject an approach that would assess eligibility for a temporary exemption from applying IFRS 9 below the reporting entity level.
- B3 If eligibility for the temporary exemption from applying IFRS 9 were to be assessed below the reporting entity level, the entity would be able to choose to apply the temporary exemption to those financial instruments that qualify for the temporary exemption and would be required to apply IFRS 9 to those financial assets that do not qualify for the temporary exemption. Hence, such an entity would simultaneously apply two Standards for accounting for financial instruments—IFRS 9 and IAS 39.
- B4 The IASB believes that if eligibility for the temporary exemption were assessed below the reporting entity level, entities that choose to apply the temporary exemption should be required to apply it to financial instruments held by all the parts of the entity that qualify. In other words, entities would not be able to choose to apply the temporary exemption to financial instruments held by some eligible parts but not others. This would help to reduce opportunities for earnings management.
- B5 The following group structure is used to illustrate assessment below the reporting entity level:



- B6 If issuing contracts within the scope of IFRS 4 is not the predominant activity of the group as a whole, HoldCo would not be eligible for the temporary exemption from applying IFRS 9 proposed in the Exposure Draft. However, if eligibility for the temporary exemption were assessed below the reporting entity level, HoldCo may be able to apply the temporary exemption to part of the group. For example, if issuing contracts within the scope of IFRS 4 is the predominant activity for Subsidiary A and its subsidiaries, in its consolidated financial statements, HoldCo:
- (a) could choose to apply IAS 39 to all of the financial instruments held by Subsidiary A and its subsidiaries; and
 - (b) would apply IFRS 9 to all its other financial instruments (ie those held by Subsidiary B and HoldCo itself).
- B7 The IASB notes that transfers of financial instruments between parts of a reporting entity that would qualify for the temporary exemption and parts of the reporting entity that would not qualify could result in gains and losses from changes in classification and measurement. Some users of financial statements have expressed concerns that such transfers could be used to manipulate earnings and could make financial statements less understandable. In addition, an underlying principle in IFRS is that consistent accounting policies are applied in consolidated financial statements. Hence, if eligibility for the temporary exemption were assessed below the reporting entity level, the IASB believes it would be necessary to introduce accounting requirements to ensure that useful information is provided to users of financial statements about transfers of financial instruments between:
- (a) parts of the reporting entity to which the temporary exemption is applied; and
 - (b) parts of the reporting entity that are not eligible for the temporary exemption.
- B8 The IASB noted that the recognition of gains or losses on transfers of financial instruments could be avoided by prohibiting changes in classification and measurement upon a transfer of financial instruments between parts of a reporting entity. However, prohibiting changes in classification and measurement upon a transfer:
- (a) would result in financial instruments that would not otherwise be in the scope of the temporary exemption being accounted for applying IAS 39;
 - (b) would result in financial instruments that would otherwise qualify for the temporary exemption being accounted for applying IFRS 9; and
 - (c) would provide entities with an opportunity to 'choose' the applicable Standard for accounting for financial instruments (ie IAS 39 or IFRS 9) by choosing where in the reporting entity to initially recognise financial instruments and then subsequently transferring those financial instruments to the part of the reporting entity where those financial instruments are intended to be used.
- B9 Instead of prohibiting changes in classification and measurement upon a transfer, the IASB indicated that transfers between different parts of a reporting

entity should be reported at fair value and any resulting income or expenses should be reported separately on the face of the statement of profit or loss. Subsequent to the transfer, the financial instrument would be accounted for applying the Standard applicable to the part of the reporting entity to which the financial instrument has been transferred. Although this approach would not address concerns about the recognition of income and expenses on internal transfers, and would still allow entities to choose which Standard to apply to its financial instruments, it:

- (a) would be consistent with the objective for the temporary exemption from applying IFRS 9, which is to ensure that financial assets that do not relate to insurance activities are accounted for under IFRS 9 and to permit financial assets that relate to insurance activities to be accounted for under IAS 39;
- (b) would provide transparency about both the fact that a transfer has occurred and the financial impact of transfers of financial instruments on the face of the statement of profit or loss; and
- (c) would avoid the added complexity for users of financial statements that would arise if financial instruments were accounted for both under IAS 39 and IFRS 9 not only within the same reporting entity but also within the same *part* of a reporting entity.

B10 In addition, the IASB notes that assessing eligibility for the temporary exemption below the reporting entity level would require additional presentation and disclosure requirements beyond those proposed in the Exposure Draft to enable users of financial statements to understand the effect of transfers between parts of the entity applying the temporary exemption and those parts that do not.

B11 The IASB discussed but rejected the following alternative approaches to identifying those financial instruments that could qualify for a temporary exemption:

- (a) Based on legal structure and by reference to regulation. Financial instruments held by a legal entity (and its subsidiaries) within a reporting entity would qualify for the temporary exemption if that legal entity is regulated as an insurance entity. (However, financial instruments held by any subsidiaries of the legal entity that are regulated as, for example, banks would not qualify for the temporary exemption.) The IASB noted that because of differences in the way insurance and banking regulation works around the world, there could be differences in how this approach would be applied in different jurisdictions.
- (b) Based on segment reporting. A reporting entity could choose to apply IAS 39 to financial instruments that are allocated to the identified operating segment that engages in insurance activities and would apply IFRS 9 to all other financial instruments held in the reporting entity. However, the IASB notes that a reporting entity may identify its segments on a basis other than by industry or the types of activities conducted. For example, a reporting entity may identify its segments on a geographical

or market basis. Such entities would not qualify for the temporary exemption. In addition, the IASB notes that this approach would provide flexibility to entities in identifying financial instruments that would qualify for the temporary exemption. This could reduce comparability between entities and provide opportunities for earnings management.

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