In brief
A look at current financial reporting issues

13 September 2016

More flexibility in the application of IFRS 9 – the IASB publishes an amendment to IFRS 4

Issue

On 12 September 2016, the International Accounting Standards Board (IASB) published an amendment to IFRS 4, 'Insurance contracts'. This addresses the concerns of insurance companies about the different effective dates of IFRS 9, 'Financial instruments', and the forthcoming new insurance contracts standard. The amendment to IFRS 4 provides two different solutions for insurance companies: a temporary exemption from IFRS 9 for entities that meet specific requirements (applied at the reporting entity level); and the 'overlay approach'. Both approaches are optional.

IFRS 4 (including the amendments that have now been issued) will be superseded by the forthcoming new insurance contracts standard. Accordingly, both the temporary exemption and the 'overlay approach' are expected to cease to be applicable when the new insurance standard becomes effective.

Key provisions

Temporary exemption from applying IFRS 9

For annual periods beginning before 1 January 2021, the amendment to IFRS 4 allows insurers to continue to apply IAS 39, 'Financial Instruments: Recognition and measurement', instead of adopting IFRS 9, if their activities are 'predominantly connected with insurance'. The exemption can only be applied at the level of the reporting entity. To assess whether activities are 'predominantly connected with insurance', two tests have to be performed. Only if both tests are passed are an insurer's activities considered to be predominantly connected with insurance.

First, an insurer assesses whether the carrying amount of its liabilities arising from contracts within IFRS 4's scope is significant, compared to the total carrying amount of all of its liabilities.

Secondly, the insurer compares the total carrying amount of its liabilities connected with insurance with the total carrying amount of all of its liabilities. In addition to liabilities arising directly from contracts within IFRS 4's scope, liabilities connected with insurance include

- non-derivative investment contract liabilities measured at fair value through profit or loss applying IAS 39, and
- liabilities that arise because the insurer issues, or fulfils obligations arising from, those insurance and non-derivative investment contracts.

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The second test is passed if the resulting percentage is either: greater than 90%; or if it is less than or equal to 90% but greater than 80%, the insurer is not engaged in a significant activity unconnected with insurance.

The assessment is made, based on the carrying amounts as at the annual reporting date that immediately precedes 1 April 2016. Under certain circumstances, a reassessment is required or permitted.

Overlay approach

Under IFRS 9, certain financial assets have to be measured at fair value through profit or loss; whereas, under IFRS 4, the related liabilities from insurance contracts are often measured on a cost basis. This mismatch creates volatility in profit or loss. By using the 'overlay approach', the effect is eliminated for certain eligible financial assets. For these financial assets, an insurer is permitted to reclassify – from profit or loss to other comprehensive income – the difference between the amount that *is* reported in profit or loss under IFRS 9 and the amount that *would have been* reported in profit or loss under IAS 39.

Financial assets are eligible for designation for the 'overlay approach' if they are measured at fair value through profit or loss under IFRS 9, but not so measured under IAS 39. In addition, the asset cannot be held in respect of an activity that is unconnected with contracts within IFRS 4's scope. If a designated financial asset no longer meets the eligibility criteria (for example, because it is transferred so that it is now held in respect of an entity's banking activities or because the entity ceases to be an insurer), it shall be de-designated; in that case, any balance accumulated in other comprehensive income relating to this financial asset is reclassified to profit or loss.

The 'overlay approach' is applied retrospectively. Accordingly, the difference between the fair value of the designated financial assets and its carrying amount is recognised as an adjustment to the opening balance of accumulated other comprehensive income. Following the same logic, if the entity stops using the overlay approach, it adjusts the opening balance of retained earnings for the balance of accumulated other comprehensive income.

Impact

Both the temporary exemption and the 'overlay approach' allow entities to avoid temporary volatility in profit or loss that might result from adopting IFRS 9 before the forthcoming new insurance contracts standard. Furthermore, by using the temporary exemption, an entity does not have to implement two sets of major accounting changes within a short period, and it can take into account the effects of the new insurance standard when first applying the classification and measurement requirements of IFRS 9.

Groups that contain insurance subsidiaries should be aware that the temporary exemption only applies at the level of the reporting entity. So, unless the whole group is eligible for the temporary exemption, whilst an eligible insurance subsidiary can continue to apply IAS 39 in its individual financial statements, the subsidiary will have to prepare IFRS 9 information for consolidation purposes. Furthermore, it should be noted that, under both approaches, significant additional disclosures are required.

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