IFRS 4 Phase II
Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Update

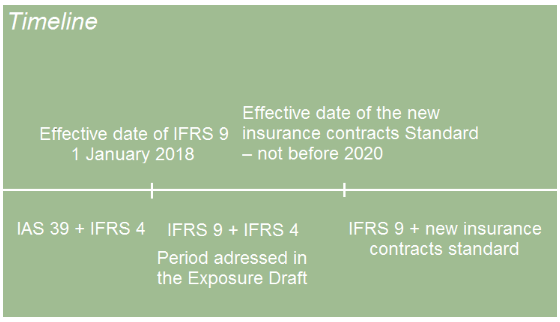
Ernst Visser | William Hines | Kurt Lambrechts

In this update, we discuss the board's decisions with respect to amendments in International Financial Reporting Standard (IFRS) 4 Insurance Contracts which were made because of transition issues arising from the different effective dates of IFRS 9 Financial Instruments and the forthcoming replacement of the current standard IFRS 4 Insurance Contracts. This briefing note is an update of our January 2016 briefing note.

INTRODUCTION

The revised insurance contract accounting standard of the International Accounting Standards Board (IASB) will not be mandatorily effective before 2020, while the new standard IFRS 9 Financial Instruments, which replaces IAS 39, will be effective on 1 January 2018. Because of this, there will be two consecutive major accounting changes in a short period of years. IFRS 9 will apply along with the current IFRS 4 Insurance Contracts accounting standard. In December 2015 the IASB has issued an Exposure Draft (ED) on this topic, which we discussed in our January 2016 Briefing Note. The final amendments to IFRS 4 are expected in September 2016. This paper contains a recap of the solutions proposed by the IASB and describes the tentative board decisions.

Figure 1: Timeline



OVERVIEW OF APPROACHES

The IASB has proposed two approaches to address the temporary effects of applying IFRS 9 with IFRS 4. The first option is called the 'overlay approach' and is available to all entities that issue insurance contracts. This approach adjusts reported income to remove any additional accounting volatility that may arise from qualifying financial assets. The second option is called the 'deferral approach' and is available to entities whose predominant activity is issuing insurance contracts. This approach provides for a temporary exemption from applying IFRS 9.

THE OVERLAY APPROACH

The overlay approach may be applied by all entities from January 2018. Under the overlay approach, an entity would apply IFRS 9 from its effective date but would be allowed at its option to reclassify from profit and loss (P&L) to other comprehensive income (OCI) the difference between how certain eligible assets are treated under IFRS 9 and how they would have been treated under the existing IAS 39. The reclassification must be shown as a separate item in profits or loss, OCI, or both, and additional disclosures will be required to help users understand the effect of the overlay approach. Assets for which the overlay approach can be used must meet the following two criteria:

1. Financial assets are measured at fair value through profit and loss when applying IFRS 9 but would not have been measured on this basis under IAS 39.
2. The financial assets are designated by the entity as relating to insurance contracts for the purposes of the overlay approach. The approach may not be applied to assets backing noninsurance liabilities.

The objective is to remove any increased volatility from P&L in a transparent and consistent manner while maximising comparability.

What are the issues?

The main concern of the two effective dates is the potential for unwarranted volatility of income that would be due to an accounting mismatch between the valuation of assets and liabilities. Certain types of assets are treated differently by IFRS 9 and IAS 39. Below are some examples of the assets whose treatment is different.

Considerations should be given to the classification of assets. The classification of assets in IFRS 9 is different from IAS 39. Fair Value through Other Comprehensive Income (FVOCI) in IFRS 9 is not the same as Available For Sale (AFS) in IAS 39. Some debt instruments that are classified as AFS when applying IAS 39 would be classified as fair value through profit or loss (FVPL) in their entirety when 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. In addition, 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 when applying IAS 39. Given that most liability accounting methods utilised under IFRS 4 today are some sort of amortised cost method, the changes in asset valuation could produce more severe accounting mismatches than with IAS 39. It is important to identify required changes on time in the classification of assets and also to identify the choices in the presentation of fair value changes of equity instruments.

THE DEFERRAL APPROACH

Entities whose predominant activity is issuing insurance contracts will have the option of deferring the application of IFRS 9 until the date the entity applies the insurance contract standard or 1 January 2021, whichever is earlier. Additional disclosures will be required for entities applying the deferral approach. The board has tentatively decided that the fair value at the end of the reporting period and the fair value change during the reporting period should be disclosed as financial assets that would be measured at fair value through profit or loss applying IFRS 9, because they do not meet the contractual cash flow characteristics test in paragraphs 4.1.2(b) and 4.1.2A(b) of that IFRS. The board has also decided that predominance should be evaluated at a reporting entity level because it is considered more useful for a reporting entity to apply only one standard. The predominance ratio 'P' is calculated by comparing the insurance contract liabilities plus the value of investment contracts at FVPL plus other connected liabilities (e.g., tax) with the total amount of its liabilities. The ratio 'P' should satisfy $P > 90\%$, or $80\% < P \leq 90\%$, if there is no significant activity unrelated to insurance. The deferral of IFRS 9 would be for all assets within the reporting entity. The predominance ratio is calculated at the annual reporting date between 1 April 2015 and 31 March 2016. The deferral approach has a fixed expiry date of 2021.

Which financial assets would qualify for the temporary exemption?

Entities that elect to apply this approach, and are qualified to do so, must apply the temporary exemption to all, rather than some, financial assets.

CONCLUSION

The board's tentative decisions have provided more clarity about the amendments we can in expect in the IFRS 4 standard in September 2016. The considerations for an entity to choose between the overlay approach and the deferral approach are broadly the same as we discussed in our January 2016 briefing note. Entities that are predominantly insurers would likely see less impact with the deferral approach, as it would continue the existing financial reporting framework with some additional disclosures. The entities could then plan to adopt the new insurance contract standard and IFRS 9 at the same time, allowing for the alignment of the accounting with the business model of the insurer. Entities that may have more diverse businesses may wish to adopt IFRS for their noninsurance business, as it may create a better accounting match to such business models. Applying IFRS 9 on a consistent basis across the entire entity or group will allow for consistent approaches and choices in the valuation of financial assets and liabilities. The overlay approach will also allow the insurance portions of such groups to limit the accounting volatility until adoption of the new insurance accounting standard.

We recommend that companies consider the transitional requirements of IFRS 4 Phase II. It is important to identify required changes in the classification of assets on time and also to identify the choices in the presentation of fair value changes of equity instruments.

HOW MILLIMAN CAN HELP

Milliman is a leading global advisor and has consultants working internationally on understanding and assessing the impact of the IASB's latest proposals for insurance contracts.

Milliman consultants can assist in understanding the proposals, including:

- The areas of consultation highlighted by the IASB
- Systems implications and design
- The influence that the ED may have on your business, including new business impact

Milliman also has extensive expertise of industrialisation of reporting processes. Integrate™ is Milliman's unique, holistic system, which gives an approach to automation and governance of actuarial reporting processes.

Built around MG-ALFA®, Milliman's industry-leading financial modelling system, and powered by Microsoft Windows Azure, Integrate represents a reimagining of the relationship between people, processes, and technology. Launched in 2012, it is the first industrialisation solution that is proven to manage risk, maximise efficiency, and unlock the full potential of the actuarial staff.

ABOUT MILLIMAN

Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in healthcare, property and casualty insurance, life insurance and financial services, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe. For further information, visit milliman.com.

MILLIMAN IN EUROPE

Milliman maintains a strong and growing presence in Europe with 250 professional consultants serving clients from offices in Amsterdam, Brussels, Bucharest, Dublin, Düsseldorf, London, Madrid, Milan, Munich, Paris, Stockholm, Warsaw, and Zurich.

CONTACT

If you have any questions or comments on this briefing paper or any other aspect of IFRS 4 Phase II, please contact any of the consultants below or your usual Milliman consultant.

Ernst Visser
ernst.visser@milliman.com
Tel +31 20 7601 801

William Hines
william.hines@milliman.com
Tel +1 781 213 6228

Kurt Lambrechts
kurt.lambrechts@milliman.com
Tel +32 2 719 00 40

Milliman does not certify the information in this update, nor does it guarantee the accuracy and completeness of such information. Use of such information is voluntary and should not be relied upon unless an independent review of its accuracy and completeness has been performed. Materials may not be reproduced without the express consent of Milliman.

© 2016 Milliman, Inc. All Rights Reserved.