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

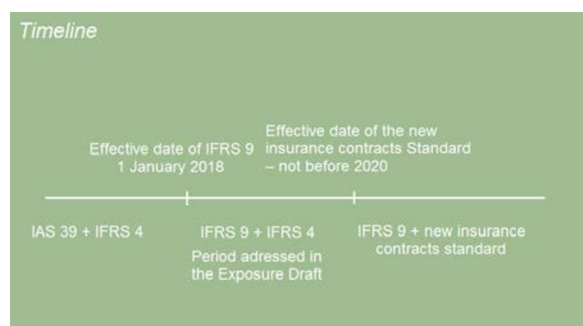
Ernst Visser
William Hines, FSA, MAAA

In this briefing note we discuss transition issues that are due to the different effective dates of International Financial Reporting Standard (IFRS) 9 Financial Instruments and the forthcoming new IFRS 4 Insurance Contracts and the proposed amendments to address these transition issues.

INTRODUCTION

In July 2014 the International Accounting Standards Board (IASB) issued IFRS 9 Financial Instruments, a revised accounting standard for valuing financial assets and liabilities that will replace IAS 39, Financial Instruments: Recognition and Measurement when it becomes effective on January 1, 2018. As the IASB's revised insurance contract accounting standard will not be effective before 2020, there will be a short period of years during which IFRS 9 will apply along with the current IFRS 4 Insurance Contracts accounting standard. In December 2015 the IASB issued for comment a proposal to allow insurers the choice of a couple of methods to deal with the potential increased volatility of income and equity during this interim period. This paper describes the issues that could exist, the IASB's proposals for addressing those issues, and the likely impact of each option proposed.

Figure 1: Timeline



ISSUES WITH IFRS 9

The IASB believes that the financial statements of insurers could be difficult to understand because of the additional temporary volatility that could occur in the income statement for entities that apply IFRS 9 prior to adopting the new insurance accounting standard. It also believes that some entities may find it difficult to apply the provisions of IFRS 9 before they can fully evaluate the effects of the new insurance standard. The IASB is also concerned about insurers applying two major accounting changes in a short period of time.

Some debt instruments that are classified as available for sale (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 utilized under IFRS 4 today are some sort of amortized cost method, the changes in asset valuation could produce more severe accounting mismatches than with IAS 39.

REMEDIES WITHIN IFRS 4

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:

- Shadow accounting: A method of adjusting the carrying amount of insurance liabilities to reflect the impact of unrealized gains and losses on assets backing the insurance liabilities when they are recognized in the financial statements, but not in the insurance contracts liability.
- 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.
- 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 and no less reliable, or more reliable and no less relevant to the needs of users. Thus, an entity applying IFRS 4 would be permitted to change its accounting policies for insurance contracts to reduce accounting mismatches.

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.

IASB PROPOSALS

The IASB is proposing to allow two options to entities that issue insurance contracts to help them address the concerns raised. The first option is called the 'overlay approach' and is available to all entities that issued 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 exposure draft is open for comment through February 8, 2016.

THE OVERLAY APPROACH

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 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.

Which entities can apply the temporary exemption?

In the exposure draft, the IASB proposes that the temporary exemption from applying IFRS 9 should be available as an option only to entities whose predominant activity is issuing insurance contracts. Predominance is assessed by comparing the amount of an entity's insurance contracts liabilities with the total amount of its liabilities. 'Predominance' is intended to be a high threshold to avoid IAS 39 being applied to assets relating to noninsurance activities to the greatest extent possible. For example, the IASB has indicated that the predominance condition would not be met if three-quarters of an entity's liabilities are liabilities arising from insurance contracts and one-quarter are liabilities arising from other activities.

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 January 1, 2021, whichever is earlier. Additional disclosures will be required for entities applying the deferral approach. When producing consolidated financial statements, an entity will need to evaluate whether the predominant activity of the group as a whole is issuing insurance contracts when considering whether the deferral approach can be applied at that level. Predominance is evaluated by comparing the insurance contract liabilities with total liabilities. The deferral of IFRS 9 would be for all assets.

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.

EXPOSURE DRAFT

The exposure draft is open for comment through February 8, 2016. An important topic the responders are invited to comment on is the eligibility for the temporary exemption from applying IFRS 9. In the proposal, it is based on the comparison of the carrying amount of an entity's liabilities arising from contracts within the scope of IFRS 4 with the total carrying amount of its liabilities. This is assessed at the reporting level. Another important topic responders are invited to comment on is the proposed expiry date January 1, 2021, for temporary exemption from applying IFRS 9.

CONCLUSION

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 (a liability accounting standard that is more consistent with the provisions of IFRS 9).

The IASB appears to be listening to preparers' concerns about the potential impact of the different adoption dates for the new accounting standard for insurer's assets and liabilities, and proposing reasonable options for dealing with them. Each approach brings its own challenges for a company in terms of determining discount rates, additional modelling requirements, and data storage needs.

In the exposure draft, respondents are invited to comment on important issues such as criteria for temporary exemptions from applying IFRS 9 as well as an expiry date for such exemptions.

We recommend that companies consider the transitional requirements of IFRS 4 Phase II. Any system or modelling developments needed to meet these requirements should be fully incorporated into the company's IFRS 4 planning process.

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 exposure draft 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.

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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
+1 781 213 6228

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