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HM TREASURY

Financial Reporting Advisory Board Paper

Insurance contracts: Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts*

Issue:	In 2004 the IASB issued IFRS 4 *Insurance Contracts*, an interim standard on insurance contracts. The publication date of the new insurance contracts standard is expected in 2016, with an earliest possible effective date being c.2020. In December 2015 the IASB published an Exposure Draft to amend the existing IFRS 4 to address the temporary consequences of the different effective dates of IFRS 9 *Financial Instruments* (1 January 2018) and the new insurance contracts standard. Both new standards are relevant to entities that issue insurance contracts. This paper discusses the IASB's **proposed amendments** to the existing IFRS 4 as a result of the earlier effective date of IFRS 9.
Impact on guidance	The 2018/19 version of the FReM may be impacted as a result of these amendments when IFRS 9 is introduced.
IFRS adaptation	The existing version of IFRS 4 applies without adaptation for the public sector context but may need to be adapted in 2018/19 when IFRS 9 is introduced.
IPSAS compliant	Insurance contracts are excluded from the scope of IPSAS 28, except in some circumstances. Entities are permitted to apply this standard to contracts that take the form of insurance contracts that involve the transfer of financial risk.
Impact on budgetary regime and Estimates	No changes proposed at this stage.
Alignment with National Accounts	No misalignment identified at this stage.
Recommendation:	That the Board note the progress of the IASB project on the new insurance contracts standards and seeks the Board's **early** views on:

	• whether an amended IFRS 4 should be adapted for the public sector; effectively disallowing the proposed amendments; and • any potential public sector implications of the differing effective dates of IFRS 9 and the new insurance contracts standard.
Timing:	Possible amendment to the 2018/19 FReM when IFRS 9 is introduced into the public sector.

DETAIL

Background

2. In March 2004 the International Accounting Standards Board (IASB) issued IFRS 4 *Insurance Contracts*; an interim standard on insurance contracts. The IASB is currently undertaking an extensive project[1] on insurance contracts and is working towards publishing a new insurance contracts standard in 2016 with an earliest possibly effective date being c.2020.

3. IFRS 4 applies, with limited exceptions, to all insurance and reinsurance contracts that an entity issues and to reinsurance contracts that it holds. The standard provides a temporary exemption from the general requirement that accounting policies should be relevant and reliable (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*) and permits the continuation of diverse practice of accounting for insurance contracts.

4. The two high level issues driving the need for a new global insurance standard are:

- improving the transparency of information to better assess the effects on the financial statements; and
- improving comparability between products, companies and jurisdictions.

5. In July 2014 the IASB issued the final version of IFRS 9 *Financial Instruments*[2]. IFRS 9 will replace IAS 39 *Financial Instruments: Recognition and Measurement* from January 2018. **Both IFRS 9 and the new insurance contracts standard will be relevant to entities that issue insurance contracts**.

6. Some stakeholders, in particular insurers, expressed concerns to the IASB about the need to implement two significant changes in accounting on different dates which could result in significant cost and effort to both users and preparers. They also highlighted that there could be a potential risk of increased accounting volatility arising in profit or loss if the IFRS 9 requirements for financial

[1] IASB insurance contracts project overview: http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Documents/2015/Dec2015-Insurance-Contracts-Overview.pdf

[2] HM Treasury paper on the final version of IFRS 9: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/389077/FRAB__122__03_-_IFRS_9_.pdf

instruments were to be applied before the new requirements for insurance contracts. The concern was over the incremental volatility of IFRS 9 when compared to that arising from applying IAS 39.

7. Some entities also expressed concerns to the IASB about having to apply the classification and measurement requirements of IFRS 9 before the effects of the new insurance contracts standard could be fully evaluated.

8. Therefore, the IASB stated at the time of issuing IFRS 9 that it would consider how to address the challenges arising from it being implemented before the new insurance contracts standard. In December 2015 the IASB published an Exposure Draft[3] to amend the existing IFRS 4 to address these interim consequences of the different effective dates.

Exposure Draft amendments to IFRS 4 *Insurance Contracts*

9. The IASB's stated aim is to balance the needs of users of the financial statements with those of stakeholders that have expressed their concerns when considering amendments to IFRS 4.

The overlay approach

10. This approach allows entities to reclassify from profit or loss to other comprehensive income (OCI) the incremental volatility in profit or loss caused by changes in the measurement of financial assets upon application of IFRS 9.

11. This means that any additional amounts recognised in profit or loss upon application of IFRS 9, compared to that arising from applying IAS 39, will be recorded directly in equity through OCI for financial instruments that are classified as fair value through profit or loss under IFRS 9 but previously were, or would have been, classified as amortised cost or available-for-sale under IAS 39.

12. All entities that issue insurance contracts would be permitted to apply the overlay approach but it can only be applied when an entity first applies IFRS 9 and <u>would only be in place until the new insurance contracts standard comes into force</u>.

13. The IASB proposed that entities adopting this approach would need:

- to show that the reclassification is shown as a separate line item in the statement of profit or loss, OCI or both;
- to include additional disclosures to enable users to understand the effect of the overlay approach on the financial statements;
- to apply IFRS 9 in full, so information provided about financial instruments of entities that issue insurance contracts is comparable with the information provided by other entities; and
- continue to apply the existing IAS 39 to relevant financial assets to calculate the adjustment.

[3] IASB Exposure Draft applying IFRS 9 with IFRS 4: http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-Draft-December-2015/Documents/ED_Applying-IFRS-9-with-IFRS-4_DEC%202015.pdf

The deferral approach

14. This temporary exemption would give entities the option to defer the effective date of IFRS 9 until the earlier of the new insurance contracts standard effective date or 2021. On expiry of this approach entities would then have the option to apply the overlay approach.

15. This approach would only apply to entities whose business model is predominantly to issue insurance contracts – i.e. purely in activities that result in contracts within the scope of IFRS 4. Only those entities that issue insurance contracts that applies to all of their financial assets are permitted to utilise the deferral approach option.

16. The Exposure Draft proposes that predominance is assessed by comparing the amount of an entity's insurance contract liabilities with the total amount of its liabilities. It is intended to be a high threshold to avoid IAS 39 being applied to assets relating to non-insurance activities, for example, banking or asset management activities.

17. An example in the Exposure Draft demonstrates that if 75% of an entity's liabilities are liabilities arising from contracts within the scope of IFRS 4 and 25% are liabilities arising from other activities, the entity would not meet the predominance condition and therefore would not be eligible for this approach.

Other mitigating measures

18. The two proposed amendments to IFRS 4 would supplement other measures, including:

- the current flexibility offered by the existing IFRS 4 in choosing an accounting policy for insurance contracts, for example, an option to adjust the measurement of insurance contracts to reduce accounting volatility; and

- the transition reliefs to be included in the new insurance contracts standard for entities that apply that standard after they apply IFRS 9.

IASB next steps

19. The deadline for comments to the Exposure Draft was in early February 2016. The IASB are currently analysing comments that it received on the proposals and has yet to decide whether it will proceed with the proposed amendments to IFRS 4. The IASB intends to complete its deliberations as soon as possible in 2016.

Insurance contracts in the public sector

20. Insurance contracts, specifically financial guarantee contracts (FGCs), were discussed by members of the IFRS 9 technical working group in 2015. Some FGCs result in the transfer of significant insurance risk and thus meet the definition of insurance contract under IFRS 4.

21. If a FGC is not an insurance contract as defined in IFRS 4 it should be within the scope of IAS 39. However, if a department issuing FGCs has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting policies applicable to insurance contracts, it may elect to apply either IAS 39 or IFRS 4 to such FGCs. This election can be made on a contract-by-contract basis and it is irrevocable. An election to account for FGCs under IFRS 4 typically results in them being

accounted for in a similar way as they would be under IAS 37 *Provisions* and hence initial recognition is not at fair value.

22. In October 2015 HM Treasury surveyed the central government sector to better understand the breadth and depth of the impact of introducing IFRS 9. As a part of this exercise departments were questioned on their current accounting treatment for FGCs and whether they apply IFRS 4 or IAS 39. Departments were also asked whether their approach would change when IFRS 9 is introduced.

23. HM Treasury received ten responses to the consultation. Three of those responses were 'nil returns' – i.e. no significant impact – and five respondents stated that they have not issued any FGCs. The remaining respondents have not explicitly asserted that their FGCs are insurance contracts and as such have not accounted for them under IFRS 4. They also do not intend to change the accounting treatment due to the introduction of IFRS 9.

24. It should be noted that in accordance with IFRS 4, UK Export Finance has taken advantage of the option in IAS 39 and elected to continue to regard its existing FGCs as insurance contracts. However, for the purposes of the Exposure Draft it is unlikely that UKEF would meet the predominance condition.

Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts* in the public sector

25. With regards to the overlay approach, HM Treasury holds the view that insurance contracts within the scope of IFRS 4 are unlikely to be material to the public sector, as demonstrated in paragraph 23 above, and so this approach is unlikely to have a substantive impact in the public sector. It is also unlikely that central government departments will be eligible to utilise the deferral exemption as they are unlikely to meet the predominance condition.

26. If the IASB decide to proceed with the proposed amendments to IFRS 4 then it is HM Treasury's early assessment that neither of these amendments should be permissible in the public sector. Therefore, when IFRS 9 is introduced the existing IFRS 4 should be adapted accordingly in the FReM until the time the new insurance contracts standard becomes effective.

27. The effect of adapting the existing IFRS 4 to exclude these amendments will:

- improve consistency of accounting policies across the public sector;
- better facilitate the consolidation of public sector entities within the Whole of Government Accounts.

Timing

28. Possible amendment to the 2018/19 FReM when IFRS 9 is introduced into the public sector.

Recommendation

29. That the Board note the progress of the IASB project on the new insurance contracts standards and seeks the Board's **early** views on:

- whether an amended IFRS 4 should be adapted for the public sector; effectively disallowing the proposed amendments; and

- any potential public sector implications of the differing effective dates of IFRS 9 and the new insurance contracts standard.

HM Treasury
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