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October 2021

Insurance Accounting Alert

IASB agrees to a classification overlay for financial assets presented in comparative periods on initial application of IFRS 17

What you need to know

IASB agrees to finalise the classification overlay:

- At its meeting on 28 October 2021, the IASB agreed to a proposed amendment to IFRS 17 for a classification overlay to address possible accounting mismatches between financial assets and insurance contract liabilities in the comparative information presented on initial application of IFRS 9 and IFRS 17
- The IASB decided to extend the scope of the classification overlay to:
  - Include all financial assets an entity holds – not only those held in respect of an activity connected with contracts within the scope of IFRS 17
  - Include entities that have applied IFRS 9 before they apply IFRS 17 for the first time, for assets that would have been redesignated in accordance with paragraph C29 of IFRS 17 if they had not been derecognised in the comparative period
- The Board agreed to one additional qualitative disclosure – a description of the approach taken in respect of impairment in the comparative amounts.
- The staff indicated that entities have a choice of either keeping the amount of IAS 39 impairment allowance or calculating an impairment amount in accordance with IFRS 9 for each financial asset to which the classification overlay is applied.
- The IASB expects to publish the final amendments to IFRS 17 in December 2021.

Overview

At its October 2021 meeting, the International Accounting Standards Board (IASB or the Board) agreed to finalise, with certain amendments, the proposals made in its Exposure Draft (ED) *Initial Application of IFRS 17 and IFRS 9—Comparative Information*, on a proposed narrow-scope amendment to IFRS 17 *Insurance Contracts* (IFRS 17 or the standard). In the ED, the IASB proposed a classification overlay for financial assets in the comparative period if certain conditions are met. This proposal is in response to concerns raised by stakeholders regarding accounting mismatches that could arise between financial assets and insurance contract liabilities in the comparative information when IFRS 17 and IFRS 9 *Financial Instruments* (IFRS 9) are first applied in 2023.

In the meeting, the IASB agreed to extend the scope of the classification overlay, but decided against any other significant changes. The Board decided to extend the scope to:

- Include all financial assets an entity holds — not only those held in respect of an activity connected with contracts within the scope of IFRS 17
- Include entities that have applied IFRS 9 before they apply IFRS 17 for the first time, for assets that would have been redesignated in accordance with paragraph C29 of IFRS 17 if they had not been derecognised in the comparative period

The Board decided to expand the qualitative disclosures of whether the entity has applied the classification overlay to also require a description of the approach taken in respect of impairment in the comparative amounts. The Board rejected respondents' suggestions that additional quantitative disclosures of the effects of the classification overlay were necessary.

The staff indicated that in terms of the impairment models that could be applied to financial assets subject to the classification overlay, entities have a choice of either keeping the amount of IAS 39 impairment allowance or calculating an impairment amount in accordance with IFRS 9 for each applicable financial asset. The staff will consider drafting improvements accordingly when preparing the final amendment.

All 12 Board members agreed with finalising the amendments as outlined above. No Board members expressed an intent to dissent from the amendment to IFRS 17.

The IASB expects to publish the final amendments to IFRS 17 in December 2021.

The story so far

The IASB issued IFRS 17 in May 2017, it then issued targeted amendments to IFRS 17 in June 2020, following the Exposure Draft (ED) on proposed *Amendments to IFRS 17* (published in June 2019 and subsequent re-deliberations based on feedback received on the ED from stakeholders). Our publication, *Applying IFRS 17: A closer look at the new insurance contracts standard (June 2021)*, provides further details on the requirements. The IASB issued Exposure Draft (ED) *Initial Application of IFRS 17 and IFRS 9 — Comparative Information* in July 2021, for which the comment period ended in September 2021.

Background

The classification overlay was designed to address accounting mismatches that can arise due to differences in transition requirements for IFRS 9 and IFRS 17. IFRS 17 requires restatement of comparatives, whereas restatement under IFRS 9 is permitted (but not mandatory) if hindsight is not required. However, restatement is prohibited for financial assets derecognised before the initial application date. The accounting mismatch caused by financial assets derecognised during the comparative period is relevant to several insurers. It is potentially significant and could make financial statements more difficult to understand.

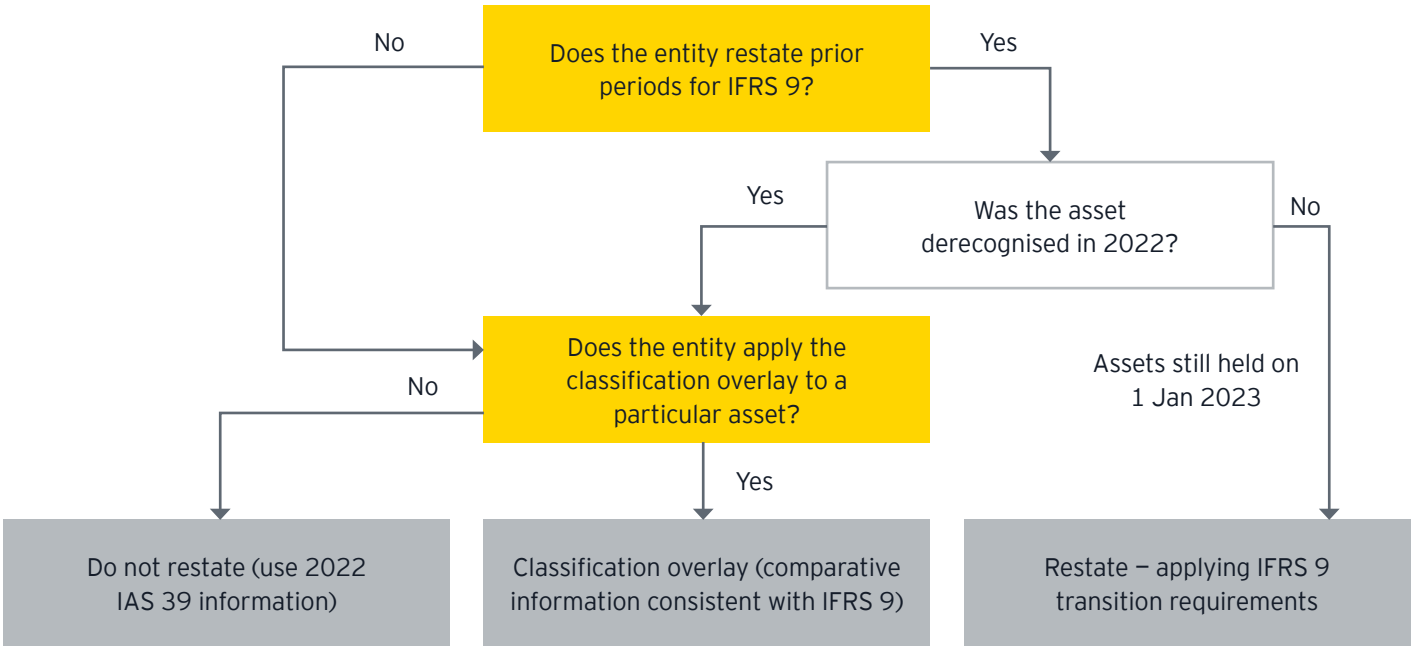
The key aspects of the proposals in the ED, which aims to address these issues, are summarised below:

The ED proposed an optional classification overlay that would:

- Apply to financial assets that are held in respect of an activity connected with contracts within the scope of IFRS 17 and to which IFRS 9 has not been applied in the comparative periods
- Allow an entity to classify these financial assets in the comparative periods based on a reasonable expectation of how they would be classified on initial application of IFRS 9
- Apply from the transition date to the date of initial application of IFRS 17
- Apply on an instrument-by-instrument basis

Further details can be found in our July 2021 Insurance Accounting Alert

Decision tree on the classification overlay and presentation of comparative information about financial assets on initial application of IFRS 9 and IFRS 17:



Based on October 2021 IASB staff paper Agenda Ref 2

Scope of the classification overlay

At its October meeting, the IASB agreed with the staff's proposals to expand the proposed scope of the classification overlay.

The Board tentatively decided to expand the scope so that an entity that first applies IFRS 17 and IFRS 9 at the same time is permitted to apply the classification overlay to any financial asset for which comparative information has not been restated for IFRS 9.

In the proposal in the ED, financial assets "unconnected with contracts within the scope of IFRS 17", such as financial assets held in respect of banking activities would not have been eligible for the classification overlay.

The IASB agreed with the staff recommendation that removing this restriction would improve the amendment. This aligns the scope of the classification overlay with that of the temporary exemption from IFRS 9 for insurers; it reduces operational complexity, and it will improve the comparative information presented on initial application of IFRS 9 by being more comparable to the IFRS 9 information presented for the reporting period. The staff papers prepared for the meeting also explained that insurers that qualified for the temporary exemption from IFRS 9, would, by definition, not have a significant proportion of financial assets unconnected with insurance activities.

The Board also tentatively decided to expand the scope of the classification overlay so that an entity that has already applied IFRS 9 is permitted to apply the overlay to a financial asset that would have been redesignated in accordance with paragraph C29 of IFRS 17 if that asset had not been derecognised in the comparative period. (Paragraph C29 applies only to financial assets that are not held in respect of an activity that is unconnected with contracts within the scope of IFRS 17.)

Respondents to the ED had noted that insurers that have already applied IFRS 9 have the same concerns as insurers that will apply IFRS 17 and IFRS 9 at the same time, about accounting mismatches that could arise in the comparative period relating to derecognised assets. These entities that have already applied IFRS 9 have an option under paragraph C29 of IFRS 17 to redesignate financial assets on initial application of IFRS 17 in order to reduce accounting mismatches. However, this redesignation cannot be applied to financial assets derecognised in the comparative period, since it applies only on initial application of IFRS 17. (For example, an entity may have measured a derecognised asset at amortised cost under IFRS 9, but on initial application of IFRS 17, it may want to present it at fair value through profit or loss (FVPL) in the comparative period in order to reduce an accounting mismatch with comparative information for insurance contracts restated for IFRS 17.)

While the IASB staff were not aware of this being a significant issue for entities that already applied IFRS 9, the Board agreed with the staff recommendation to expand the proposed scope to such entities. The use of the classification overlay would, in their view, only increase the usefulness of comparative information about financial assets presented on application of IFRS 17.

Observations from the Board meeting
Board members supported the staff proposals to expand the scope of the classification overlay. One Board member noted that having different accounting treatments for assets connected with insurance and those not connected with insurance would cause complexity for users and preparers of financial statements. Another Board member who was in favour of expanding the scope of the classification overlay to entities that had already applied IFRS 9, noted that the IASB should encourage, and not discourage, early adoption of IFRS 9.

Impairment

In the papers prepared for the meeting, the staff indicated that in terms of the impairment models that could be applied to financial assets subject to the classification overlay, entities have a choice of keeping either the amount of IAS 39 impairment allowance or calculating an impairment amount in accordance with IFRS 9 for each applicable financial asset.

The Board tentatively decided to finalise the amendments in the ED related to impairment without any changes. However, it decided that in addition to the qualitative disclosures about whether the entity has applied the classification overlay, to also require entities that apply the classification overlay to disclose whether the impairment requirements in IFRS 9 (Section 5.5) were applied to the financial assets in the comparative period.

In response to requests for clarification from respondents to the ED about the requirements related to impairment, the staff will consider drafting improvements accordingly when preparing the final amendment

Observations from the Board meeting
Board members agreed there was a need for clarity and care in drafting the wording on impairment in the final amendment, given this is an amendment to IFRS 17 rather than to IFRS 9, and there are already requirements in IFRS 9 which should not be changed.

Disclosure

The Board agreed with the staff recommendation not to require quantitative disclosure of the effect of the classification overlay. The Board considered that the costs of such disclosure requirements would likely outweigh the benefits, since the classification overlay is time-limited, targeted in scope and relates to an accounting mismatch only.

Observations from the Board meeting
Some Board members noted that the overlay only improves the usefulness of comparative information about financial assets, so it seems counterintuitive to provide additional disclosure.

One Board member observed that there will be a huge amount of changes in the first set of IFRS 17 and IFRS 9 financial statements – consequently quantitative disclosures about the classification overlay in comparative amounts could be a distraction.

The Board agreed with the staff recommendation to finalise the amendment to IFRS 17 without amending disclosures about initial application of IFRS 9. One Board member highlighted the IFRS 7 requirement for a reconciliation of classification and measurement for financial instruments from IAS 39 to IFRS 9. The IAS 39 amounts at the date of initial application of IFRS 9 will differ from the closing balances in the restated comparative amounts if the entity applies the classification overlay. That Board member felt it was important that all insurers provide the same analysis of the transition from IAS 39 to IFRS 9 regardless of the extent to which they apply the classification overlay.

How we see it

- Insurers will welcome the finalisation of this amendment to IFRS 17, and the extension of its scope. Broadening the scope of the amendment in this way will also reduce complexity and remove the need for insurers to determine, for the purposes of the classification overlay, those financial assets which are deemed to be in respect of an activity that is unconnected with insurance contracts and those which are not.
- Bank subsidiaries, and other insurers who have already applied IFRS 9, will also welcome the scope extension, as they may be faced with the same issue regarding accounting mismatches that could arise in the comparative period relating to derecognised assets.
- The classification overlay should, as stated by the IASB staff, increase the usefulness of comparative information about financial assets presented on initial application of IFRS 17. However, it remains to be seen how well users of financial statements will be able to understand how the classification overlay is applied, without any additional disclosure requirements.

Next steps

Having agreed that due process has been followed, the IASB will begin the balloting process to issue the amendments to IFRS 17. The IASB staff noted their intention to issue the amendments by the end of December 2021.

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