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Insurance Accounting Alert

IASB issues proposed amendment to IFRS 17 on classification overlay for financial assets in the comparative period on initial application of IFRS 17

What you need to know

- The IASB issued an Exposure Draft (ED) on 28 July 2021 on a proposed narrow-scope amendment to IFRS 17 *Insurance Contracts* (IFRS 17) to permit a classification overlay for financial assets in the comparative period if certain conditions are met.
- The proposal in the ED seeks to address mismatches that could arise in the accounting treatment of financial assets and insurance contract liabilities in the comparative period. (Comparatives are restated on initial application of IFRS 17, but restatement of comparatives for IFRS 9 is optional and is also prohibited for assets derecognised in the comparative period.).
- The proposed classification overlay would be optional and would:
  - Apply to financial assets that are related to insurance contract liabilities and to which IFRS 9 has not been applied in the comparative period(s), either because this is prohibited under IFRS 9 for financial assets derecognised in the comparative period, or because the entity has chosen not to restate comparatives for IFRS 9.
  - Allow an entity to classify those financial assets in the comparative period(s) based on how it expects those assets to be classified on initial application of IFRS 9, using reasonable and supportable information at the transition date.
  - Apply to comparative periods that have been restated for IFRS 17.
  - Apply on an instrument-by-instrument basis.
- It would not change the transition requirements of IFRS 9, which would still be applied only from the date of initial application of IFRS 9.
- The 60-day comment period to respond to the ED ends on 27 September 2021.

Overview

The International Accounting Standards Board (IASB or the Board) issued 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) on 28 July 2021. The IASB has 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.

Background

The issues raised by stakeholders, and addressed in the ED, relate to the fact that transition requirements apply from the date of initial application for IFRS 9 (1 January 2023 for many entities), whereas for IFRS 17, they apply from the transition date, which is the start of the previous annual reporting period[1] (1 January 2022 for many entities). While insurers are required to restate IFRS 17 comparative information on initial application, restatement of comparatives on initial application of IFRS 9 is optional, and only allowed when it can be done without the use of hindsight. In addition, if an entity does restate IFRS 9 comparative information, it is prohibited from applying IFRS 9 to any assets that have been derecognised before the initial application date.

This means that insurers who restate comparatives for IFRS 9 will have some financial assets in the comparative period (e.g., 2022) accounted for applying IFRS 9, and others applying IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39) until they are derecognised. This could create mismatches with the accounting treatment of financial assets and insurance contract liabilities in the comparative period.

Similar mismatches could arise for insurers who choose not to restate comparatives for IFRS 9 and instead apply IAS 39 in the comparative period, for example, in respect of assets measured at amortised costs while insurance contract liabilities are measured at current estimates.

Operational challenges could arise from these requirements given the population of derecognised assets would only be known at the end of the comparative period (e.g., 31 December 2022).

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

Classification overlay

The IASB proposes a classification overlay approach, which would be optional and would:

- Apply only to those financial assets to which IFRS 9 was not applied in the comparative period(s)
- Therefore, be available for both:
  - Entities that restate comparative information applying IFRS 9. For such entities, the classification overlay would be available only for financial assets derecognised in the comparative period because IFRS 9 does not apply to those assets; and
  - Entities that do not restate comparative information applying IFRS 9. For such entities, the classification overlay would be available for any financial asset other than financial assets held in respect of an activity that is unconnected with contracts within the scope of IFRS 17.
- Allow entities to align classification of these financial assets with the expected classification on initial application of IFRS 9:
  - In applying the classification overlay to a financial asset, the entity should use reasonable and supportable information available at the transition date to determine how the entity expects that financial asset to be classified on initial application of IFRS 9. Entities could, for example, use preliminary assessments performed to prepare for the transition to IFRS 9 (i.e., how they expect those financial assets to be classified when applying IFRS 9). The Board expects that entities adopting that approach could use that pre-analysis to make the assessments necessary to apply the proposed classification overlay.
  - Although the classification overlay is based on the **expected** classification as if the classification and measurement requirements of IFRS 9 had been applied to a financial asset, it would **not** require the entity to complete the business model and contractual cash flow characteristics assessments required by IFRS 9, nor would the entity be required to apply IFRS 9's expected credit loss model.
  - For debt instruments, the following classifications could apply — amortised cost, fair value through profit or loss measurement (FVPL), or fair value through other comprehensive income measurement (FVOCI).

[1] Or earlier, if more than one year of comparatives is restated.

- For equity instruments, the following classifications could apply – FVPL or fair value changes presented in other comprehensive income (FVOCI presentation).
- The difference between the carrying amount of the financial assets applying the classification overlay at the IFRS 17 transition date (1 January 2022) and the previous carrying amount at that date would be recognised in opening retained earnings (or other component of equity, as appropriate) at that date.
- The proposed amendment would be made in IFRS 17 and does not change the transition requirements of IFRS 9, which would still be applied based on the date of initial application of IFRS 9.

- Apply to all the comparative period(s) restated for IFRS 17
  - Many entities will only present one year of restated comparatives for IFRS 17. However, if an entity chooses to restate more than one comparative period on initial application of IFRS 17, the classification overlay would be applied to the earlier period as well.
- Entities may not use hindsight when applying a new accounting policy to a prior period. Entities would need to begin collecting relevant information from the transition date of IFRS 17 to apply the proposed classification overlay without the use of hindsight.
- Apply on an instrument-by-instrument basis
  - Entities may, for practical purposes, apply the classification overlay at a higher level of aggregation that is similar to the level at which the business model would be assessed.
  - Entities would not be required to separately disclose comparative information for financial assets to which the classification overlay has been applied and for those restated for IFRS 9, but would be required to disclose the fact that they have used the classification overlay.
- Not apply to those financial assets held in respect of an activity that is unconnected with contracts within the scope of IFRS 17, such as assets held in respect of banking activities.

Next steps:

Comments are due by 27 September 2021. The IASB plans to complete any resulting amendment by the end of 2021.

How we see it:

- Insurers will welcome the IASB's proposal in the ED for this amendment to address the accounting mismatches identified. 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. In particular, the issue could be relevant to insurers who currently measure financial assets related to their insurance contract liabilities at amortised cost rather than fair value, and who do not use a current measurement model in valuing insurance contracts applying IFRS 4.
- With the classification overlay, the Board is not only seeking to provide a solution to accounting mismatches, but also aims to address some concerns over operational complexity. For example, an entity should establish the classifications under the classification overlay using reasonable and supportable information at the transition date, where it can leverage its IFRS 9 'pre-analysis' in determining how it expects financial assets to be classified under IFRS 9.
- Some entities will welcome the fact that the classification overlay also applies to entities that decided not to restate comparatives for IFRS 9. For these entities, the impact of an accounting mismatch, and, thus, the impact of a potential classification overlay to mitigate it, might be larger because **all** of their financial assets in the comparative period would be accounted for under IAS 39.
- Users of financial statements will welcome having enhanced comparability between periods, to better enable them to identify and assess changes and trends.
- However, since the proposed amendment would only apply to financial assets held in respect of an activity that is not unconnected with contracts within the scope of IFRS 17, the existing IFRS 9 transition guidance would continue to apply to all other financial assets. Entities might have significant financial assets held in respect of activities that are unconnected with insurance contracts.

The story so far

The IASB issued IFRS 17 in May 2017, it then issued targeted amendments to IFRS 17 in June 2020, following on from 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.

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