



Exposure Draft expected in July 2021 on classification overlay for financial assets in the comparative period on initial application of IFRS 17

What you need to know

At its meeting on 22 June 2021, the International Accounting Standards Board (IASB or the Board) agreed to propose a 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 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) in a way that aligns with how the entity expects those assets would be classified on initial application of IFRS 9
 - ▶ 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 ED is expected to be published by the end of July 2021, with the aim to finalise the amendments by the end of the year

Overview

At its June 2021 meeting, the IASB agreed to propose 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, and discussed at the IASB's May meeting, regarding accounting mismatches that could arise between financial assets and insurance contracts in comparative information when IFRS 17 and IFRS 9 *Financial Instruments* (IFRS 9) are first applied.

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 Insurance Contracts* (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:

Background

The issues raised by stakeholders, and addressed by the Board, 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 period¹ (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 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 rates.

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 proposed classification overlay approach

The proposed classification overlay aims to resolve these issues. It would be optional and would:

- ▶ Apply only to financial assets that are related to insurance contract liabilities
 - ▶ This is in line with paragraph C29(a) of IFRS 17 which refers to those assets “*not 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
- ▶ Apply only to those financial assets to which IFRS 9 was not applied in the comparative period(s)
- ▶ The overlay approach would, therefore, be available for both:
 - ▶ Entities that restate comparative information for IFRS 9 (available only for financial assets derecognised in the comparative period, as IFRS 9 does not apply to these assets)
 - ▶ Entities that do not restate comparative information for IFRS 9 (available for any financial assets related to insurance contracts)

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

- ▶ Allow classification of such assets in the comparative period in a way that aligns with how an entity would expect to classify them on initial application of IFRS 9
 - ▶ As the proposed amendment would be made in IFRS 17, 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 overlay would **not** require the entity to apply the business model and contractual cash flow characteristics assessments required by IFRS 9 (or application of IFRS 9's expected credit loss model)
 - ▶ It is expected that entities will prepare for the classification overlay in line with approaches to preparation for IFRS 9 by "pre-analysing" how they expect assets would be classified on initial application of IFRS 9 at 1 January 2023. At that date, an entity would need to confirm the pre-analysis was accurate for those assets still recognised. This is in line with IFRS 9 requirements to make assessments for asset classification based on facts and circumstances at the date of initial application
 - ▶ 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)
 - ▶ 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 at that date
- ▶ 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 restates more than one year of IFRS 17 comparatives, the classification overlay could apply to these periods as well
 - ▶ An entity would need to collect the relevant information required for the classification overlay in each period, in order to avoid the risk 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 expected 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 those restated for IFRS 9

Observations from the Board meeting

Board members supported the staff proposals for a narrow scope amendment to IFRS 17 to eliminate accounting mismatches and foster comparability. Several noted they expected the amendment would affect a relatively small number of entities.

Board members sought clarification of several proposals described in the staff paper. For example:

- ▶ Entities need not perform the full business model and cash flow characteristics (solely payments of principal and interest (SPPI) test) assessments required by IFRS 9, but they need a reasonable basis to support the classification they would expect to apply. Determining "a reasonable basis" will need careful consideration and drafting in the ED.
- ▶ Some were concerned that an instrument-by-instrument choice of classification could encourage cherry picking. One Board member suggested that the objective of the optional overlay should be included in the basis for conclusions, or elsewhere, to guide the outcome.
- ▶ It was noted that the adjustment to equity at the transition date was not limited to retained earnings, but could include other comprehensive income.
- ▶ One board members also asked for clarification around the scope of financial assets eligible for the classification overlay and the staff noted they would use wording as elsewhere in IFRS 17 (e.g., para c29(a) with reference to assets "not held in respect of an activity that is unconnected with contracts within the scope of IFRS 17."

Some Board members suggested a 30-day comment period for the Exposure Draft proposing the change, but others felt constituents would need 60 days to fully consider the proposals. Several Board members noted the technical nature of the proposals and felt drafting could take some time to complete.

All 13 board members agreed that due process had been followed and that the staff can begin the balloting process for the ED. 12 of the 13 board members agreed with 60-day comment period. None of the Board members said they would dissent from the issue of an Exposure Draft containing the change.

Next steps:

Having agreed that due process steps have been followed, the IASB will begin the balloting process to publish an ED. The IASB staff noted their intention to publish the ED by the end of July 2021. Once the ED is published, there will be a 60-day comment period. In order to provide the intended relief for entities transitioning to IFRS 17, the staff aims to finalise the proposed narrow scope amendment to IFRS 17 by the end of 2021, (subject to stakeholders' feedback on the ED, and the Board's decisions during its redeliberations).

How we see it:

- ▶ Insurers will welcome the IASB's proposal 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.
- ▶ Some entities will welcome the clarification by the IASB 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.
- ▶ Some users of financial statements may welcome having comparative information on a more consistent basis with current reporting periods, to better enable them to identify and assess changes and trends.
- ▶ However, since the proposed amendment would only apply to financial assets that are connected with insurance activities, the existing IFRS 9 transition guidance would continue to apply to all other financial assets. Entities might have significant assets not connected to insurance contracts.



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