IFRS

STAFF PAPER

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Project	**Amendments to IFRS 4: Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts***
Paper topic	First-time adopters of IFRS Standards: Applicability of the overlay approach and temporary exemption

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Purpose of the paper

1. This paper discusses whether first-time adopters of IFRS Standards (FTAs) should be permitted to apply the overlay approach and the temporary exemption from applying IFRS 9 *Financial Instruments* (IFRS 9) (temporary exemption). It:

   (a) discusses the proposals for FTAs in the Exposure Draft *Applying IFRS 9* Financial Instruments *with IFRS 4* Insurance Contracts (Proposed amendments to IFRS 4) (the ED) and the feedback received (paragraphs 4-14); and

   (b) analyses whether those proposals should be amended to permit FTAs to apply the overlay approach and the temporary exemption. It also considers the changes needed to those approaches for application by FTAs (paragraphs 15-35).

2. In Agenda Paper 14C *Fixed expiry dates and other aspects of the temporary exemption and the overlay approach,* staff recommend that the International Accounting Standards Board (the Board) confirm the proposals in the ED that the temporary exemption would be effective for annual periods beginning on or after 1 January 2018 and the overlay approach would be effective when the entity first applies IFRS 9. Therefore, this Agenda Paper does not consider FTAs that prepare their first IFRS financial statements using IAS 39 *Financial Instruments:*

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Recognition and Measurement (IAS 39) for reporting periods that end before 1 January 2018. Such entities would no longer be FTAs on the effective date of IFRS 9 and the proposed amendments to IFRS 4. Accordingly, FTAs prior to 2018 will have the same opportunity to apply the temporary exemption/overlay approach as existing IFRS preparers[1].

Staff recommendation

3. Staff recommend that the Board modify the proposals in the ED so that:

   (a) an FTA is permitted to apply the temporary exemption when the FTA meets the qualifying criteria. An FTA must use the carrying amounts of liabilities applying applicable IFRS Standards in assessing whether it meets the predominance criterion on the date of assessment; and

   (b) an FTA is permitted to apply the overlay approach to qualifying assets. An FTA that applies the overlay approach must restate comparative information to reflect the overlay approach when the entity restates comparative information in accordance with IFRS 1.

Background

ED proposals

4. The ED proposed that FTAs would be prohibited from applying the overlay approach and the temporary exemption. Paragraph BC82 of the Basis for Conclusions on the ED noted that :

   (a) Such a prohibition would be consistent with the concepts underlying IFRS 1 *First-time Adoption of International Financial Reporting Standards* (IFRS 1), which, in general:

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[11] That is, any existing IFRS Standards preparer wanting to apply the temporary exemption could assess the predominance criterion using the carrying amounts of the liabilities reported on its balance sheet, in accordance with IFRS Standards, at the assessment date (ie the annual reporting date between 1 April 2015 and 31 March 2016, subject to the discussion about reassessment in Agenda Paper 14B *Reassessment of eligibility for the temporary exemption from applying IFRS 9* (14B)).

(i) require FTAs to apply the current version of IFRS Standards—in this case, IFRS 9; and

(ii) has as its primary objective—comparability over time within an FTA's first IFRS financial statements and between different entities adopting IFRS Standards for the first time at a given date, and as its secondary objective—achieving comparability between first-time adopters and entities that already apply IFRS Standards;

(b) FTAs could avoid any additional accounting mismatches or temporary volatility by adopting the forthcoming insurance contracts Standard early or by adopting accounting policies that are consistent with the forthcoming insurance contracts Standard, as permitted by IFRS 4. An FTA would normally be expected to comprehensively review all of its accounting policies and to amend those policies to conform to IFRS Standards; and

(c) The overlay approach and the temporary exemption are intended to address concerns raised about the temporary accounting consequences that could arise when an entity makes the transition from IAS 39 to IFRS 9 on a different date from when the entity first applies the forthcoming insurance contracts Standard. However, FTAs will be making the transition from previous national financial reporting requirements (national GAAP) to IFRS 9, rather than from IAS 39 to IFRS 9.

Feedback on the ED

5. The ED did not ask a question about FTAs. However, some respondents commented on this topic and, in general, disagreed with the proposals. While some acknowledged that the proposed approach for FTAs is consistent with the concepts underlying IFRS 1, respondents expressed the view that the concerns raised about the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard could also be applicable to some FTAs.

6. Most respondents that provided feedback on FTAs primarily focused on the temporary exemption and argued that FTAs should be able to apply it. However,

most of those respondents also recommended that FTAs should not be prohibited from applying the overlay approach for the same reasons as they gave for allowing the temporary exemption to be applied. Respondents did not give details on whether any aspects of the temporary exemption and the overlay approach (eg the scope, the eligibility criteria, the date of assessment and the required disclosures) should be amended for FTAs or should be the same as for existing IFRS preparers.

Entities that have presented financial statements applying requirements similar to IAS 39

7. Specifically, some respondents noted that an FTA might currently present financial information in their financial statements applying national GAAP that are similar to IFRS Standards. In the ED, the underlying assumption behind prohibition was that changing from national GAAP to IAS 39 to IFRS 9 is less efficient than changing from national GAAP to IFRS 9 (as discussed in paragraph 4(c)). This assumption is less valid when an FTA's national GAAP is not significantly different from IAS 39. Accordingly, respondents argue that these FTAs' position is akin to existing IFRS preparers.

8. This might be the case for:

   (a) FTAs that previously presented financial statements applying national GAAP that are substantially aligned with IFRS Standards (eg entities from Singapore[2]); and

   (b) FTAs that previously presented financial statements applying national GAAP that have requirements *for financial instruments* that are similar, or identical, to IAS 39 (eg some entities applying UK GAAP[3]).

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[2] Singapore has adopted all effective IFRS Standards, except for IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*, and has made several modifications primarily to the exemptions from consolidation and equity method in IFRS 10 *Consolidated Financial Statements and IAS 28 Investments in Associates and Joint Ventures*. Singapore also changed some transition provisions and effective dates of the IFRS Standards that it has adopted. Accordingly, entities that might qualify for the temporary exemption are currently applying the standards, known as Singapore Financial Reporting Standards (SFRS), that are substantially aligned with IFRS Standards. The non-adoption of IFRIC 2 does not affect Singapore-incorporated companies (both listed and non-listed) that might qualify for the temporary exemption, while the modifications to requirements of IFRS Standards could affect those non-listed Singapore-incorporated companies.

Entities that have produced IFRS information for consolidation purposes

9. A few respondents also noted that there is a potential conflict between the proposal in the ED to prohibit FTAs from applying the temporary exemption and the exception in paragraphs D16-D17 in IFRS 1 (reproduced in Appendix A). Paragraph D16 allows subsidiaries adopting IFRS Standards for the first time to measure assets and liabilities at the carrying amounts that would be included in the parent's consolidated financial statements if the parent adopts IFRS Standards before the subsidiary (and vice versa). A few of those respondents suggested a similar exception as that provided in D16-D17 that would allow the FTA that qualified for the temporary exemption/overlay approach to apply such an approach if the group applies the temporary exemption/overlay approach.

10. This would be the case for FTAs (eg a parent or a subsidiary of a group) that previously presented a reporting package in accordance with IFRS Standards for consolidation purposes but:

    (a) did not prepare financial statements on a standalone basis (ie those FTAs described in paragraph 3(c) of IFRS 1); or

    (b) presented individual or separate financial statements applying requirements **other than** IFRS Standards (ie those FTAs described in paragraph 3(a)(i) of IFRS 1).

    Such FTAs would already have IFRS reporting systems, internal processes and procedures and management policies in place to prepare financial information applying IAS 39 (eg some entities from Italy[4]).

11. These FTAs are concerned with the costs that could arise when different requirements are applicable to the consolidated financial statements and the individual or separate financial statements of the parent/subsidiary. For example,

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[3] According to paragraph 11.2 of FRS 102 *The Financial Reporting Standard Applicable in the UK and Republic of Ireland* entities applying UK GAAP have an accounting policy choice between applying either the provisions of Sections 11 and 12 in full or the recognition and measurement provisions of IAS 39 or IFRS 9 and IAS 39 (as amended following the publication of IFRS 9).

[4] Italian insurance companies are required to apply IFRS Standards (as adopted by the EU) only in the consolidated financial statements. However, if the insurance company is listed and does not prepare consolidated financial statements because it has no subsidiaries, application of the EU IFRS Standards is mandatory in the preparation of its individual financial statements. Some think that in 2018 it is likely that IFRS Standards (as adopted by the EU) would also apply to the individual financial statements of Italian insurance companies that are subsidiaries of other companies.

both the group and the subsidiary meet the qualifying criteria for the temporary exemption tentatively decided by the Board at its April 2016 meeting[5] and would like to use it for the consolidated financial statements. However, the subsidiary is an FTA and would be prohibited from applying the temporary exemption in its separate financial statements under the proposals in the ED.

12. Some also argue that allowing these FTAs to apply the overlay approach and the temporary exemption in their individual, or separate, financial statements may enhance comparability between the (1) individual, or separate, and (2) consolidated financial statements (assuming that the FTA and the consolidated group both qualify and elect to apply the temporary exemption or the overlay approach). Such comparability does not exist today.

Difficulty in adopting accounting policies to reduce accounting mismatches and volatility

13. Additionally, a few respondents said that it would be unreasonable to expect that FTAs could reduce the accounting mismatches or volatility by adopting the forthcoming insurance contracts Standard early or by adopting accounting policies that are consistent with that forthcoming Standard, as permitted by IFRS 4 (as suggested in paragraph BC82(b) of the ED). This is because they are uncertain of the requirements in the forthcoming insurance contracts Standard and it would be difficult to implement such changes in their first IFRS financial statements due to the short time period prior to their first IFRS financial statements.

Consistency with the Board's previous thinking on FTAs adopting IFRS 9

14. A few respondents also argued that permitting FTAs to apply the overlay approach and the temporary exemption is consistent with the Board's thinking when it developed the requirements for FTAs adopting IFRS 9. Instead of strictly adhering to the concepts underlying IFRS 1, the Board emphasised during its discussions in completing IFRS 9 that FTAs adopting that Standard should not be disadvantaged compared to existing IFRS preparers. Accordingly, these

[5] Agenda Paper 14A *Summary of the Board's decisions* summarises the Board's tentative decisions on the qualifying criteria for the temporary exemption.

respondents to the ED asked the Board to maintain a 'level playing field' between FTAs and existing IFRS preparers with respect to transitioning to IFRS 9.

Staff analysis

15. This section discusses:

    (a) Whether the Board should permit entities to apply the overlay approach and the temporary exemption (paragraphs 16-21);

    (b) if FTAs are permitted to apply the temporary exemption, whether the requirements applicable to existing IFRS preparers are appropriate or whether any modifications or additional requirements are necessary (paragraphs 22-28);

    (c) if FTAs are permitted to apply the overlay approach, whether the requirements applicable to existing IFRS preparers are appropriate or whether any modifications or additional requirements are necessary (paragraphs 29-33); and

    (d) the staff's recommendation (paragraphs 34-35).

Should FTAs be permitted to apply the temporary exemption and overlay approach

16. Staff consider that the arguments described in paragraph 4 and BC82 of the ED for prohibiting FTAs from applying the temporary exemption and the overlay approach are still valid. In particular, staff emphasise that such a prohibition is consistent with one of the concepts underlying IFRS 1—that comparability between FTAs at a given date and comparability within an FTA over time are relatively more important than comparability between FTAs and entities that already apply IFRS Standards (discussed in paragraph BC10 of IFRS 1). This is because the Board, when developing IFRS 1, was seeking to minimise the number of changes for users of financial statements comparing an FTA over time.

17. Furthermore, the staff note that the temporary exemption was intended to avoid an entity having two successive changes in a short period of time if IFRS 9 was applied before the forthcoming insurance contracts Standard. An FTA that

transitioned from national GAAP to IAS 39 in their first IFRS financial statements and then subsequently transitioned to IFRS 9 would need to implement two sets of accounting changes. In contrast, an FTA that simply adopts IFRS 9 in their first IFRS financial statements would implement only one accounting change.

18. However, in the light of the arguments discussed in paragraphs 5-14, staff accept that some FTAs are not in a significantly different position compared to existing IFRS preparers because those FTAs previously applied requirements for financial instruments under national GAAPs that are **not** significantly different to IFRS Standards. Additionally, the staff think that after the March and April meetings, the Board now has a broader rationale for permitting existing IFRS preparers to apply the temporary exemption and the overlay approach. The staff think that this broader rationale could also be applicable to those FTAs that have previously applied requirements that are **not** significantly different from IAS 39.

19. However, staff think that the argument in paragraph 18 is, in general, not applicable to FTAs that have presented financial statements applying requirements that **are** significantly different to IAS 39. If these FTAs were to be permitted to apply the temporary exemption, users of financial statements would be subject to two sets of accounting changes in a short period of time, as discussed in paragraph 17.

20. Nonetheless, staff acknowledge that some FTAs that have presented financial statements applying requirements that are significantly different to IAS 39 may have produced information applying IFRS Standards for internal purposes. This would be the case for those entities that are part of a group that reports consolidated financial statements applying IFRS Standards. Allowing such an FTA to apply the temporary exemption would reduce the costs that would arise when an FTA with a group that qualifies and applies the temporary exemption would otherwise be prohibited from applying the temporary exemption.

21. Staff note that, in confirming the temporary exemption, the Board placed less weight on the arguments that it would be costly to apply IFRS 9 before the forthcoming insurance contracts Standard because the Board noted that all entities will have to apply IFRS 9 eventually and therefore, incur the costs necessary to do so.

Modifications needed if an FTA is permitted to apply the temporary exemption

22. If the Board decides to permit an FTA to apply the temporary exemption, the question arises as to whether any modifications are needed to the Board's tentative decisions to date (and any relevant staff recommendations in this month's papers) related to that approach. This section:

    (a) considers the requirements for the temporary exemption applicable to existing IFRS preparers (ie qualifying criteria, fixed expiry date, reassessment, optionality of the approach and disclosures); and

    (b) sets out the staff's conclusion that all of those requirements are relevant and sufficient for an FTA, other than the need to modify the assessment of whether the entity's predominant activities are related to insurance (the predominance criterion), which is discussed below.

Scope and predominance criterion

23. An existing IFRS preparer would need to meet the qualifying criteria in order to be eligible to apply the temporary exemption, ie the entity must not have previously applied IFRS 9 (other than the own credit requirements in isolation) and the entity's predominant activities must be related to insurance on the date of assessment.

24. Staff believe that FTAs should be required to apply the same qualifying criteria as for entities that already apply IFRS Standards. In particular, staff think that FTAs should be required to assess whether they meet the predominance criterion at the date of assessment based on amounts determined in accordance with IFRS Standards. That is because the Board developed those criteria to identify the population of entities for which the temporary exemption should be applicable, and those criteria were based on the underlying assumption that the ratio is computed applying IFRS Standards. In addition, applying the same criteria for FTAs as for entities already applying IFRS Standards would be consistent with the argument that permitting an FTA to apply the temporary exemption is justifiable because the FTA is not in a significantly different position compared to an entity already applying IFRS Standards as discussed in paragraph 18.

25. Therefore, because FTAs would not have previously presented financial statements applying IFRS Standards on the date of assessment, the staff think that, when assessing the predominance criterion, the entity should be required to use the carrying amounts of liabilities *as if* the entity presented a statement of financial position applying IFRS Standards on the date of assessment. Existing IFRS preparers are required to use the carrying amounts presented in the entity's *financial statements* applying IFRS Standards.

26. Staff acknowledge that requiring an entity to assess the predominance criterion using the carrying amounts of liabilities *as if* the entity presented a statement of financial position applying IFRS Standards on the date of assessment would also allow an FTA to apply the temporary exemption even if it previously applied national GAAP that is significantly different to IAS 39, discussed in paragraphs 19-20. However, staff think that it would be difficult to develop requirements that would exclude those FTAs from applying the temporary exemption without introducing significant complexity and the effort of doing so would be excessive considering the short-term nature of these amendments to IFRS 4.

27. Also, staff believe that the additional condition, determining the carrying amounts of liabilities applying applicable IFRS Standards on the assessment date, is likely to result in only FTAs that already have internal reporting systems that apply IFRS Standards or not significantly different to IFRS Standards applying the temporary exemption. In other words, staff think that an FTA that applies only national GAAP that is significantly different to IFRS Standards is unlikely to apply the temporary exemption (ie apply IAS 39 in their first IFRS financial statements).

28. Paragraph D16 allows subsidiaries adopting IFRS Standards for the first time to measure assets and liabilities at the carrying amounts that would be included in the parent's consolidated financial statements if the parent adopts IFRS Standards before the subsidiary (and vice versa). Finally, the staff note that if an FTA is permitted to apply the temporary exemption, the exception in D16 and D17 of IFRS 1 can be applied **only** if both FTAs, parent and subsidiary, qualify and apply the temporary exemption on a standalone basis (ie they both apply IAS 39).

Modifications needed if an FTA is permitted to apply overlay approach

29. If the Board decides to permit an FTA to apply the overlay approach, this section discusses whether any modifications are needed to the Board's tentative decisions to date, and staff recommendations in this month's papers, related to that approach. This section:

    (a) considers the requirements for the overlay approach applicable to existing IFRS preparers (ie qualifying assets, optionality of the approach, presentation and disclosures) in paragraphs 30-31; and

    (b) sets out the staff's conclusion that all of those requirements are relevant and sufficient for an FTA, other than the need to modify the requirement for preparing comparative information on transition, which is discussed below in paragraphs 32-33.

Qualifying assets

30. In contrast to the staff recommendations on the temporary exemption, staff do not think modifications are needed to the qualifying criteria for the assets to which the entity could apply the overlay approach. The Board has tentatively decided that:

    (a) a financial asset qualifies for the overlay approach only if:

        (i) it is designated as relating to contracts that are within the scope of IFRS 4; and

        (ii) it is measured at fair value through profit or loss (FVPL) applying IFRS 9 but would not have been measured at FVPL in its entirety applying IAS 39.

    (b) an entity elects to apply the overlay approach when it first applies IFRS 9.

31. Staff note that an entity applies the qualifying criteria for the financial assets prospectively. Staff think that only those FTAs that have presented financial statements applying requirements that are not significantly different to IAS 39 are likely to choose to apply the overlay approach. That is because, in order to apply the overlay approach, an entity would need to produce financial information for designated financial assets applying both IFRS 9 and IAS 39. The staff expect that providing this information would require significant cost and effort if the

entity had not previously applied requirements similar to IAS 39. Consequently, the staff recommend that the Board does not add any additional conditions, or modifications to the existing qualifying criteria, specifically for FTAs that are permitted to apply the overlay approach.

Comparatives

32. The Board has tentatively confirmed the ED proposals that an entity should be required to restate comparative information to reflect the overlay approach only if the entity restates comparative information in accordance with IFRS 9. The IFRS 9 transition requirements on comparative information are applicable only to existing IFRS preparers.

33. IFRS 1 contains the transition requirements for FTAs including short-term relief from applying IFRS 9 in comparative periods (paragraphs E1-E2). Accordingly, staff recommend that FTAs applying the overlay approach should be required to restate comparative information only if the entity restates comparative information in accordance with IFRS 1.

Conclusion

34. Staff think there is a fine balance between the reasons for prohibiting FTAs from applying the temporary exemption and the overlay approach, and for permitting FTAs to apply these approaches in some circumstances. Those arguments are discussed in paragraphs 16-21.

35. However, on balance, staff recommend modifying the proposals in the ED so that an FTA would be permitted to apply the temporary exemption and the overlay approach in the same circumstances as existing IFRS preparers, with only the following minor modifications:

    (a) the temporary exemption: an FTA is required to assess whether it meets the predominance criterion using the carrying amounts of liabilities applying IFRS Standards (instead of information presented in financial statements applying IFRS Standards); and

(b) the overlay approach: to require comparative information to reflect the overlay approach only when the entity restates comparative information applying IFRS 1 (instead of IFRS 9).

Question—FTAs: the overlay approach and the temporary exemption

1. Does the Board agree to modify the proposals in the ED so that:

   (a) an FTA is permitted to apply the temporary exemption when it meets the qualifying criteria. When the FTA is assessing whether it meets the predominance criterion on the date of assessment, the FTA must use the carrying amounts of liabilities applying applicable IFRS Standards; and

   (b) an FTA is permitted to apply the overlay approach to qualifying assets. A FTA that applies the overlay approach must restate comparative information to reflect the overlay approach when the entity restates comparative information in accordance with IFRS 1?

Appendix A—Excerpt from Appendix D of IFRS 1 *First-time Adoption of International Financial Reporting Standards*

A1. This appendix contains paragraphs D16-D17 of IFRS 1.

Exemptions from other IFRSs

Assets and liabilities of subsidiaries, associates and joint ventures

D16 If a subsidiary becomes a first-time adopter later than its parent, the subsidiary shall, in its financial statements, measure its assets and liabilities at either:

(a) the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRSs, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary (this election is not available to a subsidiary of an investment entity, as defined in IFRS 10, that is required to be measured at fair value through profit or loss); or

(b) the carrying amounts required by the rest of this IFRS, based on the subsidiary's date of transition to IFRSs. These carrying amounts could differ from those described in (a):

(i) when the exemptions in this IFRS result in measurements that depend on the date of transition to IFRSs.

(ii) when the accounting policies used in the subsidiary's financial statements differ from those in the consolidated financial statements. For example, the subsidiary may use as its accounting policy the cost model in IAS 16 *Property, Plant and Equipment*, whereas the group may use the revaluation model.

A similar election is available to an associate or joint venture that becomes a first-time adopter later than an entity that has significant influence or joint control over it.

D17 However, if an entity becomes a first-time adopter later than its subsidiary (or associate or joint venture) the entity shall, in its consolidated financial statements, measure the assets and liabilities of the subsidiary (or associate or joint venture) at the same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the entity acquired the subsidiary. Notwithstanding this requirement, a non-investment entity parent shall not apply the exception to consolidation that is used by any investment entity subsidiaries. Similarly, if a parent becomes a first-time adopter for its separate financial statements earlier or later than for its

consolidated financial statements, it shall measure its assets and liabilities at the same amounts in both financial statements, except for consolidation adjustments.