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16 February 2016

Dear Sir

Exposure Draft ED/2015/11: Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts - Proposed amendments to IFRS 4

We are pleased to comment on the above Exposure Draft (the ED). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the ED.

We support the IASB's efforts to address issues arising from the different effective dates of IFRS 9 *Financial Instruments*, and the new insurance standard, and agree that there are potentially significant associated costs for preparers and users of financial statements that arise from those different dates. We encourage the IASB to finalise the amendments, and the new insurance standard, as soon as possible.

We agree with a number of the proposals in the ED, including that both the overlay approach and the temporary exemption from IFRS 9 should be made available. We also agree that these should be optional in order that entities that wish to adopt IFRS 9 are able to do so; for some insurers, the different effective dates may not be as significant as for others due to the existing diversity in accounting for insurance contracts.

In general, we support the overlay approach as proposed. However, we believe that further consideration needs to be given to the criteria that need to be met for the temporary exemption from IFRS 9. Without changes being made, we believe that the eligibility conditions as proposed would result in a significant number of entities that issue contracts within the scope of IFRS 4 being inappropriately precluded from applying this approach.

For the purposes of the temporary exemption from IFRS 9, we believe that the focus should be on the significance of accounting issues arising from an entity's insurance activities. Consequently, we suggest a two stage approach which we believe would suitably restrict the application of the temporary deferral of IFRS 9 to a limited number of entities, while at the same time making its availability more consistent among different entities. The two tests are:

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1. An entity should demonstrate that a majority of its operating activities are derived from the issue of insurance contracts within the scope of IFRS 4; and
2. The liabilities test should focus on liabilities arising from contracts with customers, excluding those liabilities that are backed either by assets that are measured as at FVTPL under IAS 39, with the same measurement attribute being expected to be applied under IFRS 9, or by assets that are outside the scope of the financial instruments standard (because the accounting for these assets that back liabilities will not be affected by the adoption of IFRS 9).

In contrast to the approach proposed in the ED, this would result in two entities with identical business activities being treated in the same way, regardless of whether they were financed by equity or debt, and regardless of the extent of their other non insurance related liabilities (such as tax, lease obligations and deferred revenue).

We also believe that the level at which the predominance test is applied should be legal entity level, as illustrated in Appendix B of the ED. This could result in the temporary exemption from IFRS 9 being made available, and 'ringfenced' to those entities (or part(s) of an entity) which have a predominant activity of issuing insurance contracts within the scope of IFRS 4. This would also deal with issues arising from entities that carry out both banking and insurance activities, each of which might be very large businesses.

We also note that, if this approach was not applied and IFRS was applied by each subsidiary in its own separate financial statements (or at sub consolidation level) then, under the approach proposed in the ED, the temporary exemption from IFRS 9 might be available (and used, for the reasons set out in question 1 to the ED) by part of an overall consolidated group, with adjustments then being required for the purposes of the ultimate parent's consolidated financial statements. We do not believe that the associated costs are justified.

We acknowledge that an approach of legal entity level could result in some (consolidated group) entities simultaneously applying two IFRSs for accounting for financial instruments (IAS 39 and IFRS 9). However, because these would be expected to be applied to different trading activities, we anticipate these would typically be disclosed as part of the segmental reporting analysis. This would enable users of financial statements clearly to distinguish between those parts of a business where IFRS 9 has been adopted, and others where IAS 39 has continued to be applied.

Our responses to the questions in the ED are set out in the attached Appendix.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)20 7893 3300 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan

Global Head of IFRS

Appendix

Question 1 - Addressing the concerns raised

Paragraphs BC9-BC21 describe the following concerns raised by some interested parties about the different effective dates of IFRS 9 and the new insurance contracts standard:

- *a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before the new insurance contracts Standard (paragraphs BC10-BC16).*
- *b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated (paragraphs BC17-BC18).*
- *c) Two sets of major accounting changes in a short period of time could result in significant cost and effort for both preparers and users of financial statements (paragraphs BC19-BC21),*

The proposals in this Exposure Draft are designed to address these concerns.

Do you agree that the IASB should seek to address these concerns? Why or why not?

We agree that the IASB should seek to address these concerns, which represent the most significant consequences arising from the different effective dates, and agree with much of the rationale set out in the ED. However, contrary to paragraph BC20, we also believe that significant costs could arise from a requirement for preparers to implement two major standards in relatively quick succession, including the need to explain the related effects to users of their financial statements.

Question 2 - Proposing both an overlay approach and a temporary exemption from applying IFRS 9

The IASB proposes to address the concerns described in paragraphs BC9-BC21 by amending IFRS 4:

- *a) To permit entities that issue insurance contracts within the scope of IFRS 4 to reclassify from profit or loss to other comprehensive income some of the income of expenses arising from designated financial assets that:*
    - *i. Are measured at fair value through profit or loss in their entirety applying IFRS 9 but*

ii. *Would not have been so measured applying IAS 39 (the 'overlay approach') (see paragraphs BC24-BC25)*

b) *To provide an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4 (the 'temporary exemption from applying IFRS 9') (see paragraphs BC26-BC31).*

Do you agree that there should be both an overlay approach and a temporary exemption from applying IFRS 9? Why or why not?

If you consider that only one of the proposed amendments is needed, please explain which and why.

We agree with the proposal for an overlay approach as well as deferral. The overlay approach provides an alternative solution for those entities that either will not, or are not permitted, to apply the deferral approach.

Question 3 - The overlay approach

Paragraphs 35A-35F and BC32-BC53 describe the proposed overlay approach.

a) *Paragraphs 35B and BC35-BC43 describe the assets to which the overlay approach can be applied. Do you agree that the assets described (and only those assets) should be eligible for the overlay approach? Why or why not? If not, what do you propose instead and why?*

b) *Paragraphs 35C and BC48-BC50 discuss presentation of amounts reclassified from profit or loss to other comprehensive income applying the overlay approach. Do you agree with the proposed approach to presentation? Why or why not? If not, what do you propose instead and why?*

c) *Do you have any further comments on the overlay approach?*

a) Application of the overlay approach

We agree with the criteria to be applied in determining whether assets are eligible for the overlay approach.

b) Presentation of amounts reclassified from profit or loss to other comprehensive income

We agree in principle with the presentation requirements. However, it is not clear from paragraph 35C (or paragraph 35A) whether the amount to be reclassified is before or after

tax. We note that this is clarified in the Basis for Conclusions (BC 32) and believe that this should be stated explicitly in the standard itself.

On the basis that the amounts referred to in paragraph 35C are pre-tax, it is then not clear how tax adjustments (including deferred tax) relating to amounts that are removed from profit or loss and transferred to other comprehensive income should be dealt with. We believe that guidance should be included to state clearly whether the related tax adjustment should also be transferred, or should remain in profit or loss.

It is not entirely clear from paragraph 35E, in particular for the purposes of subparagraph (a), whether the required approach in that paragraph applies on initial application of the overlay approach, or to the period(s) after initial application. When read in conjunction with paragraph 41K, it would appear that it is the latter, and we suggest that the first line of paragraph 35E is amended to read:

> 'After it applies the transitional requirements in paragraph 41K, an entity that applies the overlay approach:'

In addition, paragraph 35E does not cover financial assets that are designated as relating to contracts within the scope of IFRS 4 on initial recognition. We suggest that an additional subparagraph is added, which could read:

> 'may designate a financial asset as relating to contracts within the scope of this IFRS on initial recognition.'

c) Further comments

We note that paragraph BC42 provides, as an example of a change in the relationship between the financial asset and the contracts within the scope of IFRS 4:

> '...an asset is transferred between an insurance business segment and a non-insurance business segment.'

We believe that, in addition to a transfer between business segments, that the test should include a requirement that the asset is no longer held to fulfil insurance liabilities for which the overlay approach is being used. This would assist in avoiding the risk of entities seeking to achieve a particular accounting outcome by transferring an asset from one part of its business to another, while at the same time making no change to the purpose for which the asset is being held.

We do not agree with the requirement in paragraph 35F that if an entity that stops using the overlay approach because it no longer issues contracts within the scope of IFRS 4, it is prohibited subsequently from applying the overlay approach. It is possible that an entity which owns an insurance business, to which it applies the overlay approach, might dispose of that business and subsequently after a period of time acquire a different insurance business which enters into similar insurance contracts as the previous business and follows the same or

similar accounting policies in accounting for them in accordance with IFRS 4. We see no reason why, on the acquisition of the second insurance business, the entity should be prohibited from applying the overlay approach.

Question 4 - The temporary exemption from applying IFRS 9

As described in paragraphs 20A and BC58-BC60 the Exposure Draft proposes that only entities whose predominant activity is issuing contracts within the scope of IFRS 4 can qualify for the temporary exemption from applying IFRS 9.

a) Do you agree that eligibility for the temporary exemption from applying IFRS 9 should be based on whether the entity's predominant activity is issuing contracts within the scope of IFRS 4? Why or why not? If not, what do you propose instead and why?

As described in paragraphs 20C and BC62-BC66, the Exposure Draft proposes that an entity would determine whether its predominant activity is issuing contracts within the scope of IFRS 4 by comparing the carrying amount of liabilities arising from contracts within the scope of IFRS 4 with the total carrying amount of its liabilities (including liabilities arising from contracts within the scope IFRS 4).

b) Do you agree that an entity should assess its predominant activity in this way? Why or why not? If you believe predominance should be assessed differently, please describe the approach you would propose and why.

Paragraphs BC55-BC57 explain the IASB's proposal that an entity would assess the predominant activity of the reporting entity as a whole (ie assessment at the reporting entity level).

c) Do you agree with the proposal that an entity would assess its predominant activity at the reporting entity level? Why or why not? If not, what do you propose instead and why?

a) The use of a predominance test

Our understanding of the proposed predominance test is that it is intended to limit the number of entities which would qualify to defer the effective date of IFRS 9. We agree that this is an appropriate principle, but believe that it needs to be linked more clearly to the concerns raised by constituents (outlined in question 1) and to the summary of the IASB's proposal in the introduction to the ED that states:

> 'This temporary exemption is targeted at entities that are most affected by the different effective dates of IFRS 9 and the new insurance contracts standard...'

We disagree with the proposals as drafted because we believe that they would prevent many insurers which are significantly affected by the different effective dates of IFRS 9 and the new insurance standard from being eligible to apply the temporary exemption from IFRS 9. We understand the IASB's rationale for making the scope of the temporary exemption narrow, due to the improvements in accounting that IFRS 9 is expected to bring. However, we believe that amendments could be made to the criteria for the temporary exemption from IFRS 9 which would result in a wider range of significantly affected entities being capable of its application, while ensuring that it cannot be applied by entities where the temporary exemption would be inappropriate. We have outlined suggestions for how this could be achieved below in our responses to questions 4b) and 4c).

b) The assessment of 'predominant activity'

We agree that a clear, straightforward and understandable approach should be followed in determining whether an entity's predominant activity results in the issue of contracts that fall within the scope of IFRS 4. However, we believe that the proposed approach is significantly flawed. Instead of identifying an entity's predominant activity, the proposed approach will instead for many entities identify whether they have significant liabilities that arise from items such as debt financing, employee benefits and tax which then result in them being precluded from applying the temporary exemption from applying IFRS 9. We consider that this is inappropriate, and disagree with the IASB's assertion in the final sentence of paragraph BC64. However, we believe that amendments could be made to the proposed approach which would result in the test remaining relatively simple while at the same time giving results that are more reflective of an entity's activities and being understandable for users of financial statements.

We believe that the predominance test should be structured to require a two-step approach:

- whether the issue of insurance contracts within the scope of IFRS 4 represents the majority of an entity's operating activities; and
- a comparison of the carrying amount of liabilities arising from contracts within the scope of IFRS 4 with the carrying amount of all liabilities arising from contracts with customers (except for liabilities that are backed by assets within the scope of IAS 39 that are measured at Fair Value through Profit or Loss (FVTPL) and would also be measured at FVTPL in accordance with IFRS 9, or are backed by assets that are not within the scope of the financial instruments standards).

Step 1: Whether the issue of insurance contracts within the scope of IFRS 4 represents the majority of its operating activities

In order to be eligible to apply the liability predominance test, an entity should first demonstrate that a majority of its operating activities arise from the issue of contracts within the scope of IFRS 4. We consider that this test is necessary in order to eliminate the risk that an entity might inappropriately seek to apply the temporary exemption from IFRS 9.

This also links to our proposed approach to the liability predominance test (see below), which is designed to focus on those entities that issue insurance contracts and will be most affected by the adoption of IFRS 9. As part of this test, we have suggested excluding from both the nominator and denominator liabilities that are backed by assets within the scope of IAS 39 that are measured at Fair Value through Profit or Loss (FVTPL) and would also be measured at FVTPL in accordance with IFRS 9, or are backed by assets that are not within the scope of the financial instruments standards. This is because there will be no change in accounting for these assets when an entity adopts IFRS 9.

As an example of how the 'majority of activities' test would operate to exclude an entity from the liability predominance test, an entity might have a predominant activity of carrying out investment management services, and measure financial assets backing its liabilities at FVTPL. The entity also issues a small number of insurance contracts within the scope of IFRS 4. Because the liabilities arising from the investment management services would be eliminated from the predominance test, if this were the only test to be applied then the entity might qualify for the temporary exemption from IFRS 9. However, if a first test of whether issuing contracts within the scope of IFRS 4 represents a majority of its operating activities, the entity would not qualify to carry out the predominance test.

A further example of an entity that would not qualify is an entity which has a main activity of running car dealerships, and has an insurance subsidiary which sells motor insurance policies to customers who purchase cars. Because liabilities would typically not be recorded in respect of transactions for the sale and maintenance of cars, and depending on other amounts recorded within liabilities by the group, the insurance liability recorded by the subsidiary could represent a substantial part of the consolidated group's liabilities. However, because the majority of the consolidated group's trading activities would relate to the sale and maintenance of cars, the consolidated group would not qualify to carry out the predominance test.

We anticipate that this 'majority of activities' test would be straightforward to apply as, for many entities, information disclosed in their segmental analysis could be used. We note that even if an entity's segments are determined on the basis of geographic areas, the entity wide disclosures specified in IFRS 8.32 would typically include information about revenues derived from products and services. This might go some way to addressing the IASB's objection in paragraph B11(b) of the ED to an analysis based on segmental reporting.

Step 2: A comparison of the carrying amount of liabilities arising from contracts within the scope of IFRS 4 with the carrying amount of all liabilities arising from contracts with customers

Because the focus should be on whether the predominant business activities of an entity give rise to contracts within the scope of IFRS 4, we believe that the appropriate comparison to be made is between:

- the total carrying amount of liabilities arising from contracts with customers that are within the scope of IFRS 4; and
- the total value of liabilities arising from all contracts with customers, excluding liabilities that are backed by either financial assets measured at FVTPL under IAS 39 which would also be measured at FVTPL under IFRS 9 or by assets not within the scope of the financial instruments standards. For this purpose, contracts with customers would include banking services in order that customer account liabilities are captured.

Liabilities that are backed by either financial assets measured at FVTPL under IAS 39 which would also be measured at FVTPL under IFRS 9 or by assets not within the scope of the financial instruments standards would be excluded, because the purpose of the proposed amendments to IFRS 4 is to deal with measurement mismatches that arise from the adoption of IFRS 9. If assets backing liabilities are already measured at FVTPL and will continue to be so measured under IFRS 9, the issue will not arise; similarly, if the assets are not within the scope of the financial instruments standards, then the adoption of IFRS 9 will not affect their measurement.

The outcome of this approach would be to exclude certain liabilities from the predominance test, without which two otherwise identical entities could pass or fail the predominance test simply because (for example) one of them has substantial borrowings, finance lease obligations, tax liabilities and/or a defined benefit retirement plan.

For the purposes of determining the carrying amount of liabilities that arise from contracts with customers that are within the scope of IFRS 4, we note that for some entities, an adjustment would be required for contracts that contain a deposit component (see IFRS 4.10-12). This is because IFRS 4 contains an option, provided that the insurance liability is sufficiently large, to account for the obligations arising from a hybrid contract as an insurance contract in its entirety. However an entity could, if it wished, account for the liabilities arising from the same contract in accordance with IFRS 4 for the insurance component, and in accordance with IAS 39 for the deposit component. We believe that where an insurer has bifurcated a contract into IFRS 4 and IAS 39 components then, for the purposes of the predominance test, the insurance liability should include both the IFRS 4 and the IAS 39 components. If this approach was not followed, for two identical entities that issue insurance contracts which contain a deposit component, one could pass the predominance test and the other fail that test, simply because one of them has chosen to bifurcate the liabilities.

c) The level at which predominant activities are assessed

We understand and acknowledge the IASB's desire to maintain consistent accounting policies within a single set of financial statements. However, we believe that the temporary exemption from applying IFRS 9 has features which mean that it is appropriate to take a wider view in this case.

Consequently, we support the approach set out in Appendix B of the ED with the assessment being carried out at legal entity level. In contrast to the 'single entity' approach, this could result in the temporary exemption from applying IFRS 9 being made available (and, importantly, being ringfenced and limited) to only those trading activities of an entity where the predominant activity gives rise to contracts within the scope of IFRS 4. The accounting approach for all other activities could be to adopt IFRS 9 with effect from 2018. Although this would result in an entity simultaneously applying two IFRSs for accounting for financial instruments (IAS 39 and IFRS 9), we would expect that the different trading activities would typically be disclosed separately as part of the entity's segmental analysis, in accordance with IFRS 8. Consequently, users of financial statements would be able clearly to distinguish between parts of the business where IFRS 9 has been adopted, and others where IAS 39 has continued to be applied.

Addressing the potential manipulation of earnings

We acknowledge the concerns that, if an entity applied IAS 39 and IFRS 9 at the same time, it might be in a position to manipulate its earnings by transferring assets from one part of its business to another. We believe that this could be addressed in a number of ways:

- For any financial asset transferred from an entity with predominant insurance activities (IAS 39 accounting) to an entity with other business activities (IFRS 9 accounting) or vice versa, a change in the basis of accounting for the financial asset might only be permitted if the financial asset had either ceased to be used, or had started to be used, for the purposes of insurance activities.
- Any gain or loss arising from the transfer of a financial asset from IAS 39 accounting to IFRS 9 accounting could be required to be disclosed in a separate line item on the face of the statement of profit or loss. As a further safeguard, this separate line item could be required to be included immediately after a required line item for a subtotal of 'profit before tax before gains or losses attributable to transferred financial assets' with the normal 'profit before tax' line item being included as usual.

Accounting for interests in joint ventures and associates that carry out insurance activities

It is possible that an investor, which may or may not have predominant insurance activities, may have interests in one or more joint ventures and associates which themselves may or may not have predominant insurance activities.

If our suggested approach were adopted, then in the event that either the investor, or one or more of its investees, had predominant insurance activities and all entities with predominant insurance activities chose consistently to apply either the overlay approach or the temporary exemption from IFRS 9, then no issues would arise (even if the ultimate reporting entity did not on an overall basis have predominant insurance activities).

However, a question arises about the appropriate approach to be followed in the event that one or more joint ventures or associates in which an entity has an interest take an approach which is inconsistent with that of the investor, or where a number of different approaches are taken by the joint ventures and associates. We believe that, in the interests of practicality, the accounting approaches adopted by each joint venture and associate should be preserved in the financial information used for the purposes of equity accounting by the investor. Although this might result in a degree of inconsistency in accounting approach by each underlying entity, we believe that the costs associated with making all of the accounting approaches consistent would be likely to outweigh the benefits to be obtained, in particular due to the temporary nature of the overlay approach and the exemption from applying IFRS 9.

Should consideration be given to analysing activities at below legal entity level?

We have considered whether there would be merit in an approach under which a group could look below legal entity level (perhaps on the basis of whether a 'silo' exists, as contemplated in IFRS 10). This might have its attractions, because the availability of the temporary exemption from applying IFRS 9 would not be affected by whether an entity's different trading activities are carried out from separate subsidiaries (an entity might instead have a series of divisions within a single legal entity). However, we do not support this approach. In practice, we would expect substantially all entities to have separate legal entities for their insurance activities; in addition, it is unlikely that the strict criteria in IFRS 10 for a silo to exist would be met in practice, meaning that some form of relaxation of the requirements would be needed in order to make the approach operational. We are concerned that this could result in unintended consequences.

Question 5 - Should the overlay approach and the temporary exemption from applying IFRS 9 be optional?

As explained in paragraphs BC78-BC81, the Exposure Draft proposes that both the overlay approach and the temporary exemption from applying IFRS 9 would be optional for entities that qualify. Consistently with this approach, paragraphs BC45 and BC76 explain that an entity would be permitted to stop applying those approaches before the new insurance contracts Standard is applied.

a) *Do you agree with the proposal that the overlay approach and the temporary exemption from applying IFRS 9 should be optional? Why or why not?*

b) *Do you agree with the proposal to allow entities to stop applying the overlay approach or the temporary exemption from applying IFRS 9 from the beginning of any annual reporting period before the new insurance contracts Standard is applied? Why or why not?*

We agree with both proposals as they permit entities to apply IFRS 9, which we regard as being superior overall to IAS 39, in full without any restrictions.

We also agree that entities should be permitted to stop applying the overlay approach or the temporary exemption from applying IFRS 9 only at the beginning of annual reporting periods. Permission for changes at more regular intervals (for example, from the start of each interim reporting period) would be likely to result in significantly increased complexity on transition to IFRS 9, and would also be likely to make the related annual financial statements more difficult to understand.

Question 6 - Expiry date for the temporary exemption from applying IFRS 9

Paragraphs 20A and BC77 propose that the temporary exemption from applying IFRS 9 should expire at the start of annual reporting periods beginning on or after 1 January 2021.

Do you agree that the temporary exemption should have an expiry date? Why or why not?

Do you agree with the proposed expiry date of annual reporting periods beginning on or after 1 January 2021? If not, what expiry date would you propose and why?

We support the proposal for an expiry date for the temporary exemption from applying IFRS 9, and note that the proposed expiry date of annual periods beginning on or after 1 January 2021 would appear to link to the likely effective date of the new insurance standard.

In that context, we note that in January 2016 the IASB completed its technical discussions in respect of the new insurance standard, and will be asked for permission to start the balloting process (which is anticipated to take approximately one year) at its February 2016 meeting. Assuming that this permission is given, we urge the IASB to ensure that the new IFRS is issued as soon as possible in order that a 2021 effective date remains appropriate.

In the event that the effective date of the new insurance standard needed to be later than annual periods beginning on or after 1 January 2021, a question might arise about whether the temporary exemption from applying IFRS 9 should also be extended. In principle, unless the delay was solely due to the IASB taking more time than expected to finalise its drafting

based on decisions which have been taken to date, we would not support an extension. While we believe that it is appropriate for a temporary exemption from applying IFRS 9 to be given to entities that are affected by the different effective dates of IFRS 9 and the new insurance standard, any further flexibility in the expiry date might result in debates being continued about technical issues related to the new insurance standard on which the IASB has already concluded.